82-1483

No. ________

IN THE

Supreme Court of the United States

October Term, 1982

SIMONE C. ANDRE,

Petitioner,

-against-

MERRILL LYNCH READY ASSETS TRUST,
MERRILL LYNCH ASSET MANAGEMENT, INC.,
MERRILL LYNCH, PIERCE, FENNER & SMITH, INC.
and IRVING L. GARTENBERG,

Respondents.

**PETITION FOR A WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT**

SIDNEY B. SILVERMAN, ESQ.
Attorney for Petitioner
SILVERMAN & HARNES
135 East 36th Street
New York, New York 10016
(212) MU4-3333

(13660)

QUESTIONS PRESENTED

1. Did the court below err in holding that the only breach of fiduciary duty actionable under §36(b) of the Investment Company Act, as amended, was the charge of an excessive advisory fee?

2. Did the court below err in holding that "processing costs" constituting distribution costs as defined by §12(b) of the Investment Company Act, incurred by an investment company's investment adviser's affiliate, were properly considered in passing on the fairness of an investment advisory fee under §36(b) where the Trustees were not fully informed of the nature of such costs, the shareholders of such investment company received no information concerning such costs and offsetting benefits, and the affiliate had expressly waived compensation pursuant to its contract

under which the trial court found such processing services were performed?

3. Did the court below err in holding that it was the duty of trustees to ferret out information concerning the adviser's operation, rather than the duty of such adviser to disclose it?

4. Did the court below establish an erroneous standard for disclosure to shareholders under the Investment Company Act, when it held that shareholders of a fund were not required to be informed of anything more than that "the non-affiliated fund Trustees...had considered extensive relevant information before continuing in effect the Fund's agreement with the Manager."

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Petitioner prays that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Second Circuit, entered on December 3, 1982.

OFFICIAL AND UNOFFICIAL REPORTS OF OPINIONS OF COURTS BELOW

On the merits; Gartenberg v. Merrill Lynch Asset Management, Inc., 694 F.2d 923, [Current] Fed. Sec. L. Rep. (CCH) ¶99,001 (2d Cir. 1982); 528 F. Supp. 1038, [1981-1982] Fed. Sec. L. Rep. (CCH) ¶98,386 (S.D.N.Y. 1981).

On the issue of demand: Gartenberg v. Merrill Lynch Asset Management, Inc., 91 F.R.D. 524, [1981-82] Fed. Sec. L. Rep. (CCH) ¶98,283 (S.D.N.Y. 1981).

STATEMENT OF JURISDICTION

The jurisdiction of this Court is invoked by petition for writ of certiorari to the United States Court of Appeals for the Second Circuit pursuant to 28 U.S.C. §1254(1) for review of a final judgment, dated and entered December 3, 1982.

RELEVANT STATUTES AND REGULATIONS

Investment Company Act of 1940, as amended, Sections 15(c) and 36(b); (15 U.S.C. §80a-15 (c); and 80a-35(b)); and Rule 12b-1 promulgated thereunder; (17 C.F.R. §270.12b-1)), the text of which are set forth in the separately bound appendix submitted herewith.

STATEMENT OF THE CASE

Procedural History

Plaintiff Irving L. Gartenberg ("Gartenberg"), a shareholder of the Merrill Lynch Ready Assets Trust (the "Fund"), commenced an action in the United States District Court for the Southern District of New York, pursuant to §36(b) of the Investment Company Act of 1940, as amended (the "Act"), 15 U.S.C. §80a-35(b), seeking the recovery of allegedly excessive compensation received by the Fund's investment adviser, defendant Merrill Lynch Asset

Management, Inc. ("MLAM") and Merrill Lynch, Pierce, Fenner & Smith, Inc. ("MLPF&S"), an affiliate of MLAM. Both defendant MLAM and MLPF&S are subsidiaries of Merrill Lynch & Co. ("Merrill Lynch"). Plaintiff Simone C. Andre ("Andre") commenced a separate action in the same district court, which in addition to a claim of excessive compensation, charged that a false and misleading proxy statement was used to obtain shareholder approval of the investment advisory contract with defendant MLAM.

Plaintiff Andre also claimed, following discovery, that the non-interested trustees had not been furnished with all material reasonably necessary to enable them to evaluate fully the advisory contract, and that the principal underwriting contract and the investment advisory contract were unlawfully assigned.

On the eve of trial, the district court ruled that demand upon the Fund's board of trustees was a necessary prerequisite, and dismissed the complaints for failure to make such demand prior to instituting the lawsuits.*

On December 28, 1981, the district court issued an order and opinion dismissing the actions.** On December 30, 1981, judgment was entered. Plaintiff Andre filed her Notice of Appeal to the United States Court of Appeals for the

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* However, as plaintiff Gartenberg had recently made demand and such demand had been refused, the court further ordered that the complaints be deemed amended, as if demand had been made and refused, as of the date of the court's order, and that the actions be deemed commenced on that date, in order to limit the trial to claims for compensation received within the statute of limitations contained in §36(b), namely, one year.

** The court held that plaintiff Andre's contentions that defendants had violated §§15 and 20 of the Act were not properly before it, but stated, "for the sake of completeness," that they were without merit.

Second Circuit on January 25, 1982, and plaintiff Gartenberg, on January 29, 1982.

On December 3, 1982, the Second Circuit entered its judgment affirming the district court's final judgment of dismissal. The Court of Appeals, however, stated that the district court had erred on the issue of demand on the directors, and that such demand was not a necessary prerequisite to a §36(b) suit. The Court of Appeals agreed with the district court's determination of the procedural stance of plaintiff Andre's §§15 and 20 claims, and held that they were therefore, not raised on appeal.

Plaintiff Andre filed the instant petition for certiorari with this Court on March 3, 1983.

Factual Background

The Fund is a registered open-end investment company. Its portfolio consists almost entirely of short-term obligations issued by the Federal government and major banks.

The Fund is the largest by far, of what are commonly known as, money market funds. At the time of trial, its net assets had reached $19 billion. There were approximately one million shareholders of the Fund.

The investment adviser of the Fund, MLAM, is required by the Advisory contract, to perform the following routine services for the Fund: select and trade in money market securities, manage the Fund's administrative affairs and provide office space and related facilities. MLAM, in turn, receives a

fee based upon a percentage of the Fund's net assets. The present fee structure has been in effect since May 8, 1979, and is calculated at the following annual rates:

Net Assets	Rate of Fee
Not exceeding $500 million	0.50%
In excess of $500 million but not exceeding $750 million	0.425%
In excess of $750 million but not exceeding $1 billion	0.375%
In excess of $1 billion but not exceeding $1.5 billion	0.35%
In excess of $1.5 billion but not exceeding $2.5 billion	0.325%
In excess of $2 billion but not exceeding $2.5 billion	0.30%
In excess of $2.5 billion	0.275%

In 1980, MLAM received a fee of over $33 million from the Fund, and its expenses were approximately $1.5 million, including extraordinary legal expenses. In 1981, at the time of the trial, a fee of over $55 million, was anticipated with expenses at approximately the 1980 level.

Shareholders of the Fund have the option of effecting transactions in Fund shares in two ways. The Bank of New York (the "Bank") acts as the Fund's custodian and transfer agent. Shareholders may draw checks, wire funds and make deposits in person or by mail, through the Bank. The Bank maintains records of each account, receives and disburses all money invested in or withdrawn from the Fund, and reinvests daily the dividends accruing to the shareholders. The Bank sends monthly statements to all shareholders reflecting

the activities in their accounts. The Bank receives $13 per account per annum from the Fund and an additional $.15 per check drawn.

In addition to The Bank of New York, MLPF&S, the brokerage affiliate of MLAM, renders certain services with respect to transactions in Fund shares, which the district court found were performed pursuant to a selected dealer agreement entered into with another affiliate, Merrill Lynch Funds Distributor, Inc., ("MLFD") nominally the Fund's principal underwriter.* Thus, MLAM "imports" MLPF&S's services to "process" Fund orders. A shareholder of the Fund, instead of dealing directly with the Bank, may call his account executive at

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* Such selected dealer agreement is not in the record.

MLPF&S and arrange to purchase and redeem Fund shares through him. The information received is funneled to the Bank, and all transactions are ultimately handled by it. In processing orders and sales, MLPF&S serves as a conduit, and its activities are an acknowledged substitute, at least in part, for the advertising of money market funds which are not affiliated with a broker-dealer. The broker's processing has enabled the Fund to grow to its immense size. In providing processing services, MLPF&S incurs certain costs which have been referred to as "processing costs," and receives certain benefits. Estimates of costs ranged from $1.50 to $9.74 per transaction. The benefits, however, discussed below in greater detail, are admittedly substantial, but have never been quantified. It is the relationship

between these costs, and the concommitant benefits and the fee received by MLAM from the Fund and the disclosures made to the independent Trustees and shareholders with respect to such costs and benefits, which form the core of the instant case.

The record herein demonstrates that the minimal disclosure made to the shareholders served not to inform, but rather, to mislead them. The result was that shareholders could not have had any idea of what services they were acquiring by payment of the advisory fee. Thus, for example, shareholders were never informed that they were being charged through the advisory fee, for processing services provided by MLPF&S. In fact, Fund prospectuses represented that the Merrill Lynch broker affiliate had advised the Fund that it did not charge

a fee therefor.

Fund shareholders were never informed that the cost to process each transaction through MLPF&S had been estimated to be as high as $9.74, while at the same time, the cost per transaction handled by the Bank was a maximum of 15 cents.

These facts were withheld from shareholders by respondents, because they feared that an above-the-table transaction charge would damage Fund sales, as it had when the Fund was first formed and such charge was revealed.* As Arthur Zeikel, president of MLAM stated:

> "We could not disclose our arrangement because it had not been approved or sanctioned by shareholders or trustees. If it ever came to light, it would damage our credibility."

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* A transaction charge was originally exacted when the Fund was formed. This charge was subsequently dropped, whereupon the Fund began its spectacular growth.

In addition, shareholders were never informed that the trustees, as early as 1979, had become "uneasy" about the profits of the adviser, a fact with respect to which one trustee stated:

> "If I was concerned about them I would assume also that some shareholders might be concerned about them, and so yes."

Accordingly, the record reflects that respondents failed to disclose important information highly relevant to investment decisions required of both shareholders and the trustees.

The plaintiffs contended that the broker's "processing" costs were, as a matter of law, improperly included in the advisory fee. However, the district court found that with or without consideration of the processing costs, such fee was fair. That court also found that the benefits offsetting such costs could not be quantified. The

Second Circuit, held that both processing costs and offsetting benefits should be taken into account. Nevertheless, that court held that the plaintiffs had failed to establish that the offsetting benefits rendered the fee received by MLAM so excessive as to constitute a breach of fiduciary duty.

Although benefits acknowledged as "vast," were never quantified, and the adviser's profits, which, as noted, had made the trustees "uneasy", were never disclosed to the shareholders, the Court of Appeals held that disclosure to the shareholders and Trustees of the Fund had been sufficient under §36(b). In so finding, the Second Circuit placed the burden of obtaining relevant information concerning the Advisory Fee, the processing costs and the offsetting benefits (all requiring sophisticated

computer equipment and expertise) upon the independent Trustees, without regard to the burden of full disclosure which the Act places upon the investment adviser and its affiliates. Moreover, the Second Circuit established a diluted standard of materiality of disclosure to shareholders of a fund, which, in effect, leaves them unable to evaluate knowledgeably, prior director approval.

Plaintiff submits that the standards established by the Second Circuit are in direct conflict with decisions of this Court and of other circuits and directly contravene the statutory scheme of the Act which Congress intended for the protection of all investment company shareholders. This is one of the first decisions rendered under §36(b), and its holding, if allowed to stand, will, petitioner submits, serve to deprive shareholders of money market funds, who

have invested billions of dollars, of vital safeguards which Congress has striven for many years, to ensure that they have.

ARGUMENT

Section 36(b) of the Investment Company Act of 1940 provides that "the investment adviser of a registered investment company shall be deemed to have a fiduciary duty with respect to the receipt of compensation for services" paid by the investment company or its security holders. Although the well-established duties of a fiduciary to its cestui que trust are many, the Second Circuit, in its decision in the instant case, ignored all but one of such duties, limiting its scrutiny to the issue of whether the advisory fee charged to the Fund was excessive.

Petitioner submits that the record herein confirms that the fee was, in

fact, so large as to constitute a breach of the adviser's fiduciary duty. In addition, however, such record discloses the commission of other breaches of trust which the Second Circuit deemed not encompassed by §36(b), including the breach of the adviser's duties of loyalty and complete candor.

The upshot of the decision of the Court of Appeals, if allowed to stand, will be that §36(b) will, in the future, provide less protection to the Fund and its shareholders than is furnished elsewhere by the federal securities laws, or indeed, by the Act itself, prior to §36(b)'s enactment. This view of §36(b) is, petitioner submits, as demonstrated below, patently in error, and should be reversed.

I. IN JUDGING EXCESSIVENESS, THE SECOND CIRCUIT ERRED IN INCLUDING THE BROKER'S "PROCESSING" COSTS IN THE ADVISORY FEE CALCULUS.

The fiduciary duty imposed upon an adviser by §36(b) is essentially one of "undivided loyalty."* In a judicial assessment of loyalty, the conduct of a fiduciary is held to a higher standard "than would prevail in the case of an ordinary business relation." The imposition of such a standard is predicated "upon a recognition, and a necessary distrust, of the infirmities of human nature," and its mandatory application relieves the court "of the necessity of searching particular consciences."** Thus, as Bogert has stated:

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* Galfand v. Chestnutt, 545 F.2d 807 (2d Cir. 1976).

** Kerr on Fraud and Mistake, p. 368.

> "It is a well known quality of human nature that it is extremely difficult, or perhaps imposible, for an individual to act fairly in the interests of others whom he represents and at the same time to consider his own financial advantage. In most cases, consciously or unconsciously, he will tend to make a choice which is favorable to himself, regardless of its effect on those for whom he is supposed to be acting."*

In this case, the adviser, primarily or solely to enhance the business of its affiliated broker, undertook to offer and furnish certain processing services to Fund customers as a alternative to those provided by the Bank. The Second Circuit in affirming the district court, held that the latter was "entitled" to deduct the costs of processing incurred by the Manager" in calculating its "net profits." When such costs were included in the consideration of the over-all

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* Bogert, Trusts, 5th Ed., pp. 344-346.

advisory fee, the Second Circuit found that petitioner had failed to show such fee to be excessive.

Petitioner submits that the inclusion in the advisory fee of the expenses incurred in processing shareholder transactions, would constitute a breach of the adviser's duty of loyalty and as discussed below, such expense is not properly chargeable to the Fund. Further, petitioner contends, if such expense is not included, the adviser's duty is likewise breached, since without the offset of such charges, the fee is undeniably excessive when viewed in the context of the fiduciary standard.

A. Processing Costs Incurred By Merrill Lynch, Pierce, Fenner & Smith, Inc. Should Not Have Been Considered As A Matter Of Law, In Weighing The Fairness Of The Advisory Fee.

(1) Without Considering The Processing Costs, The Adviser's Fees Are Clearly Excessive.

As noted, an essential element of the Second Circuit's conclusion that unfairness had not been demonstrated, was its consideration of the so-called "processing costs"* as an item of expense which could legitimately offset the investment advisory fee.** The

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* See Note 4: The Trial Court specifically found that the processing services were not contracted for in the Investment Advisory Contract but rather were performed under a selected dealer contract pursuant to the Distribution Contract with the Fund's underwriter.

** "Processing" costs consisted of costs over and above those of the Bank, allegedly incurred by MLPF&S, in those instances in which the customer instigated purchases or redemptions of shares through the adviser's affiliate.

determination was significant, since without consideration of such costs, the record reveals an enormous and egregious profit to the investment adviser. Thus, in 1980, the investment adviser received a fee of $33,098,456, while the total expenses incurred in that year, including extraordinary items, amounted to only $1,567,847. In 1981, the investment adviser's expenses were anticipated to be the same, and its fee, over $55 million. Plaintiffs' expert witnesses testified as to the excessive nature of that phenomenal profit. Coleman Abbe, a former president of a mutual fund adviser, testified that such fee was "outlandish". Martin Shubik, Seymour Knox Professor of Mathematical Institutional Economics at Yale University, testified that based upon the various factors considered by economists in determining fair levels of profit

for any business, the ratio of fee to costs for MLAM and return on average expenses for 1980 was "in an economic sense, spectacular." Such spectacular fees were, in no way, deserved, Professor Shubik opined, since the performance of the Fund was mediocre, and the routine nature of its operation as a money market fund, not only required no unusual foresight or creativity, but in addition, rendered the enterprise "as close to riskless as one could get."

Accordingly, without consideration of the so-called "processing" costs, the fee structure of the Fund is totally indefensible. Moreover, such structure must remain indefensible since, as discussed _infra_, inclusion of processing costs in the advisory fee is unlawful and improper.

B. "Processing" Costs Should Not Be Considered In Assessing The Fee.

The cost of the alleged processing services performed by MLPF&S is not properly a consideration in the judicial evaluation of the advisory fee, for four reasons separately dealt with below:

(1) In the Fund's prospectus MLPF & S expressly waived compensation for its services rendered under the selected dealer contract, pursuant to which the district court found processing services were performed;

(2) Processing costs constitute distribution or selling expenses which should not be borne by the Fund;

(3) The costs of processing by MLPF&S must be offset by benefits derived therefrom;

(4) Inadequate disclosure was made to the Trustees with respect to processing services and costs, and shareholders

were never informed of such costs and their relation to the advisory fee.

(1) Respondents Breached Their Fiduciary Duty By Seeking, Under The Advisory Contract, Compensation Which They Had Elsewhere Waived.

In its determination of whether the terms of the investment advisory contract were fair, the Second Circuit erroneously held that it was proper to consider the cost to MLPF&S of providing processing services, despite the fact that the broker affiliate is not a party to the contract, nor is processing called for by the terms of the advisory contract.

As the district court found, these processing services were performed pursuant to a selected dealer agreement between MLPF&S, the broker, and MLFD, the Fund's distributor. Although the selected dealer agreement permitted the broker to charge a fee for its services, MLPF&S specifically waived such charge.

As the prospectus to the shareholders stated:

> "Merrill Lynch has informed the Trust that it does not charge such a fee."

By allowing respondents to recover payment from the Fund, of compensation which had previously been waived, the courts below not only ignored the most basic tenets of fiduciary law, but of contract law as well.

It is a long recognized principle of common law that if a person expressly waives compensation for the performance of services and then performs such services, he is not entitled to recover in quantum meruit. This rule was forcefully and clearly stated by the renowned 19th century English jurist, Sir Frederick Pollock, Chief Baron, as follows:

> "[I]f a person agrees to serve another for nothing...if he does serve he cannot claim any compensation in respect of the service

> which he has agreed to do for nothing. He could not say at first 'I will serve for nothing' and afterwards 'I will have a salary.' If a person has done work without consideration, it is a good answer to any claim in respect of it that he agreed to do so...."*

Thus, Corbin states that with respect to a promise to render services without compensation:

> "If the promise is executed and the promised performance is actually rendered, the promisee can safely receive it without any liability to the payment of compensation."**

These rules were totally disregarded below. Such disregard was particularly significant herein, since it would seem to follow, _a fortiori,_ that conduct which is forbidden where one party is dealing with another in an

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* _Walker_ v. _Hill,_ 5 H. & N. 419, 420 (Exch. 1860).

** I Corbin on Contracts (3rd Ed. 1963) §114, p. 499. See also Restatement, Restitution, Section 57, and Comment a thereto. (1937).

arms-length transaction, must be even more vigorously proscribed where the parties are a self-dealing fiduciary and its beneficiary. Nevertheless, the Second Circuit found the broker's charge not to be a breach of duty. Such finding is, petitioner submits, in error.

(2) Processing Costs Constitute Distribution Expenses Which Cannot, As A Matter Of Law, Be Considered In Determining The Fairness Of The Fee.

From the time of the initial drafting of the 1940 Act, there has been concern that funds might be made to bear the burden of distribution expenses incurred for the benefit of its controlling persons. Alfred Jaretzki, one of the participants in the drafting of the Act, stated with respect to §12(b):

> "Apparently the Commission was particularly fearful of the possibility that open-end investment companies in their formative stages

> might be made to shoulder the unprofitable burden of selling and distributing their shares during the period of heavy expenses and small return, building up the investment company for the benefit of some controlling person.*

Thus, it has been deemed unlawful for a fund to bear directly, selling and distribution expenses, and the fund's adviser was prohibited from passing any subsidization of the underwriing function on to the fund's shareholders in the form of a higher management fee.

In 1972, the Commission flatly stated:

> "[T]he cost of selling and purchasing mutual fund shares should be borne by the investors who purchase them and thus presumably receive the benefits of the investment, and not even in part, by the existing shareholders of the fund who often derive little or no benefit from the sale of new shares. To impose a portion of the selling cost upon

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* <u>The Investment Company Act of 1940</u>, 26 Wash. U.L.Q. 303, 324-325 (1941).

> the existing shareholders of the fund may violate principles of fairness which are at least implicit in the investment Company Act.*

In 1976, the Commission announced that it would hold hearings on the issue of distribution expenses. However, after such hearings, the Commission reaffirmed its position with respect to the general impropriety of the use of fund assets to cover its distribution expenses, directly or indirectly. Moreover, the staff was instructed to cease the issuance of no-action letters on the subject, and those concerned were advised that the prohibited practices would, if carried out, be done at the risk of violation of §36.**

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* SEC, "Statement on the Future Structure of the Securities Markets" (Feb. 1972),in BNA Sec. Reg. and L.Rep. No. 137 pt. II at 7.

** ICA Release 9915, 4 Fed. Sec. L. Rep. (CCH) ¶47,105 (Sept. 7, 1977).

The underlying concern of the SEC was expressed in terms of the inherent conflict of interest between the adviser and the fund, where the advisory fee is based upon the size of a fund.* This factor is, of course, present in the instant case, and is further compounded by the avowed use of the Fund by respondents as a readily available pool of customers and assets from which brokerage business could be solicited and obtained. Indeed, Robert Diemer, director of financial services of MLPF&S, stated that every investment made in the Fund presents MLPF&S with a unique opportunity "to turn that money from a [Fund] account to the purchase of an equity security." Thus, an added dimension of conflict is presented,

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* Investment Company Act Release No. 10252, Fed. Sec. L. Rep. (CCH) ¶81,603 (1978).

since the expansion of brokerage business is a powerful force impelling the increase in the size of the Fund's assets and the exploitation thereof for the benefit of the adviser's affiliated persons.

Until the issuance of Investment Company Release Number 11414 on October 28, 1980, the general position of the SEC had been to oppose the bearing of expenses associated with the distribution and sales of open-end management investment companies by such companies. Rule 12b-1, promulgated on the aforesaid date and discussed in such release, modified the SEC's previous policy within narrowly drawn and carefully circumscribed bounds. To provide safeguards against potential abuse, the SEC mandated that shareholders and independent director approval be obtained only after full disclosure is made to

them of all material aspects of any plan adjusting the method of financing distributions. The rule states:

> "For purposes of this section, such a company will be deemed to be acting as a distributor of securities of which it is the issuer, other than through an underwriter, if it engages directly or indirectly in financing any activity which is primarily intended to result in the sale of shares issued by such company, including, but not necessarily limited to, advertising, compensation of underwriters, dealers, and sales personnel, the printing and mailing of prospectuses to other than current shareholders, and the printing and mailing of sales literature.*

While processing costs are not specifically mentioned in the rule itself, the list of items is not intended to be exhaustive, but merely illustrative. The Commission stated that it:

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* 17 C.F.R. §270.12b-1; ICA Release No. 11414, Fed. Sec. L. Rep. CCH ¶48,162 (Oct. 28, 1980).

"has historically been concerned with whether funds are paying for distribution in substance and not with the form of particular arrangements. In this connection, it should be noted that section 48(a) of the Act [15 U.S.C. 80a-47] in effect prohibits doing indirectly that which cannot be done directly. Therefore, the Commission believes that the rule should apply to indirect expenses as well as direct expenses."*

It explained that:

"If a fund makes payments which are ostensibly for some other purpose, and the recipient of those payments finances distribution, the question arises whether the fund's assets are being used indirectly.**

The Commission emphasized in promulgating Rule 12b-1 that: "<u>It is the Commission's view that an indirect use of fund assets results if any allowance is made in the adviser's fee to provide money to finance distribution.</u> Therefore, when an adviser

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* Release 11414, [1980] Fed. Sec. L. Rep. (CCH) ¶82,678.

** <u>Supra.</u>

finances distribution, fund directors in discharging the responsibilities in connection with approval of the advisory contract must satisfy themselves either that the management fee is not a conduit for the indirect use of the fund's assets for distribution or that the rule has been complied with."* Rule 12b-1 specifically provides that payments to selected dealers constitute examples of distribution expenses. Thus, the payments to MLPF&S which were made pursuant to a selected dealer agreement, were precisely those which the SEC explicitly states, in Rule 12b-1, cannot be considered as a factor in evaluating the advisory fee.

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* Investment Company Act Release No. 11414 (Oct. 28, 1980).

Petitioner contends that as a result of the consideration of processing costs in determining the fairness of the management fee to the investment adviser, the Fund has been made indirectly and improperly to bear distribution expenses. In this case, the record amply demonstrates that the so-called processing costs incurred in securing and maintaining shareholders' accounts were considered a promotional expense in lieu of advertising by the defendants.* They resulted primarily from a hand-holding operation engaged in by the broker's registered representatives

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* As discussed below, none of this information was clearly disclosed by the investment adviser to the Trustees. Instead, as discussed above, the Second Circuit improperly concluded that the duty lies with the Trustees to ferret out information, rather than with the fiduciary investment adviser to make complete disclosure.

which was "geared to greater dealer involvement in the fund distribution process."

Thus, the Second Circuit erroneously restricted the definition of selling or distribution expenses, by limiting such expenses to "promotional expenses" which were clearly so labelled, such as advertising and sales literature "designed to create new sales of no benefit to existing shareholders."* Petitioner submits that no dichotomy should be made between expenses which are unabashedly distributional in nature, and those which are designed to look otherwise, but whose primary function is to sell. This was recognized by the adviser's counsel who, prior to

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* Second Circuit Opinion, n. 4 (Appendix A 19).

the adoption of Rule 12(b)-1, in 1980, instructed the trustees that the "processing services provided the Funds by Merrill Lynch unquestionably have distribution aspects," a patently accurate statement. Accordingly, since as MLAM's president admitted, the broker's processing services perform the same function, and serve as a substitute for the heavy advertising and direct mail campaigns utilized by funds unaffiliated with brokers, such processing services are likewise a distribution activity, "primarily intended to result in the sale of shares," and should be treated as such.

(3) The Advisory Fee Must Be Offset By All Benefits Accruing To The Fiduciary And Its Affiliates.

Substantial benefits inured to Merrill Lynch as a result of MLPF&S's processing services, including an

increase in the broker's available customer base, and the maintenence of equity accounts at MLPF&S by Fund customers who chose to utilize the transfer service between Merrill Lynch investments, supplied by the broker. Although the Second Circuit conceded the existence of such benefits (characterized by MLAM's president as "vast"), and found their quantification possible with the use of today's sophisticated computer equipment, that court, nevertheless, held that the adviser was not required to determine such benefits or to account for them. Such a holding ignores the well-hewn duty of "loyalty," and flies in the face of established fiduciary law.

In determining whether a fiduciary's compensation is fair, it is a most elementary principal under the common law, with respect to self-dealing

transactions, that all benefits accruing to the fiduciary and its affiliates from their dealings with the _cestui_ must be taken into account.* The fiduciary has the duty to present a full and accurate accounting of such benefits. It is not enough for a fiduciary to give notice to the _cestui_ that a benefit exists, "leaving the principal to inquire what it is and how much."**

These common law principles are applicable herein. The legislative history of the Act and the language of §36(b), itself, clearly indicate that benefits received by an affiliate of the investment adviser are subject to its duty of loyalty, under that section.

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* Bogert, Trusts (5th Ed.) p. 346; _Albright v. Jefferson County National Bank_, 292 N.Y. 31, 53 N.E. 2d 753 (1944).

** _Advanced Realty Funding Corp. v. Bannink_, 27 O.R. 2d 193, 196-197 (Ct. App. 1979).

Thus, the Second Circuit in the instant case, correctly stated: "These benefits to an affiliate in the Merrill Lynch organization to the extent quantifiable, should be taken into account in determining whether the Manager's fee meets the standard of 36(b)". As discussed below, however, the court erred in placing the burden of quantifying such benefits upon the independent trustees and plaintiffs, shareholders of the Fund, without regard for the duty of the investment adviser to furnish such information under the Act, and the long-standing principles of fiduciary law.

II. THE SECOND CIRCUIT MISCONSTRUED §36(b)'S BURDEN OF PROOF IN FINDING THAT THE FIDUCIARY DUTY OWED BY THE ADVISER TO THE FUND IS NOW LESS UNDER §36(b) THAN THAT OWED PRIOR TO 1970.

Prior to the enactment of the 1970 amendments to the Investment Company

Act, lawsuits attacking the fees paid by mutual funds to their investment adviser arose in many various guises. Thus, for example, complaints were filed which alleged that fund directors and investment advisers had breached their fiduciary duty to the fund by their failure to recapture brokerage commissions, by their improper valuation of fund assets, and by their charging of excessive advisory fees.

Despite the disparate nature of these several lawsuits, the courts, in deciding these claims, almost universally focused on one, common, fundamental duty which the investment adviser owed to the fund, namely, that of full and complete disclosure. This duty was most clearly set forth by the First Circuit in Moses v. Burgin, and adopted by

the Second Circuit in Fogel v. Chestnutt:*

> "Whatever may be the duty of disclosure owed to ordinary corporate directors, we think the conclusion unavoidable that Management defendants were under a duty of full disclosure of information to these unaffiliated directors in every area where there was even a possible conflict of interest between their interests and the interests of the fund."

Consequently, prior to 1970, the courts agreed that when examining transactions between a fund and its investment adviser, the threshold determination that a court was required to make, was that full disclosure of all relevant facts had been made by the adviser to the fund, and more particularly, to the independent directors thereof. If the duty of full disclosure was not met, then the courts were precluded from

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* Moses v. Burgin, 445 F.2d 369, 376 (1st Cir.) cert. denied, 404 U.S. 994 (1971); Fogel v. Chestnutt, 533 F.2d 731, 745 (2d Cir. 1975), cert. denied, 429 U.S. 824 (1976).

examining the merits of an uninformed decision by the independent directors, since such directors could not have been found to have exercised their reasonable business judgment.

In 1970, Congress codified this duty of full disclosure with the enactment of §15(c), and in addition, it expressly granted shareholders a private right of action against the fund's investment adviser for any breach of the adviser's duty "with respect to the receipt of compensation," by enacting §36(b).

With these two sections, it is clear that Congress intended to strengthen shareholder remedies against the investment adviser, not weaken them. Yet the decision of the Second Circuit in the instant lawsuit, predicted on reasoning which runs counter to the Congressional intent, lessens the protections afforded to fund shareholders. An analysis of the

Second Circuit's decision reveals that that court, in effect, turned the Act on its head, and placed a far heavier burden on fund shareholders to prove a breach of fiduciary duty than had heretofore existed.

As noted supra, it is petitioner's contention that the processing costs incurred by the broker are not properly chargeable to the Fund and, therefore, should not be considered when judging the fairness of the advisory fee. If, however, such costs are charged to the Fund, then petitioner submits that no determination of the fairness of the fee can be made without calculating as an offset, the resulting benefits which the Court of Appeals found to accrue to the affiliates of the adviser.

The Second Circuit agreed with petitioner. It stated specifically that "[t]hese benefits to an affiliate in

the Merrill Lynch organization, to the extent quantifiable, should be taken into account in determining whether the Manager's fee meets the standard of §36(b)."* Moreover, the court went on to say that it was "unpersuaded" that such benefits could not have been quantified, as respondents had urged.

However, despite the fact that the Second Circuit thus, found that full disclosure had not been made to the independent trustees, the court held that this was not a violation under §36(b), of respondents' fiduciary duty, because petitioner had not proven that the advisory fee was excessive. In addition, the court held that it was the duty of the independent trustees to ferret out the undisclosed information,

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* (Emphasis Added).

not that of the adviser to make such information known to them.

The issue presented to this Court by the decision of the Second Circuit is whether Congress, by passing §36(b), which expressly placed a fiduciary duty upon the adviser with respect to the receipt of compensation, intended to abrogate existing duties already recognized by the courts. Did Congress intend to place a heavier burden of proof on plaintiff shareholders than had existed prior to the enactment of §36(b)? Petitioner submits that Congress did not so intend. Yet, implicitly, such is the holding of the Second Circuit.

As discussed above, prior judicial decisions had determined at the outset, whether full disclosure had been made to the independent directors. Thus, the cases of Fogel v. Chestnutt,

and Galfand v. Chestnutt were decided in favor of plaintiffs, based upon a threshold determination, without any further inquiry into the gravamen of plaintiffs' complaints,* that the advisers had violated their fiduciary duty by failing to disclose all material facts. The Second Circuit, however, based upon a faulty interpretation of §36(b), inverted this prior procedure. Noting that §36(b) placed the burden of proving a breach of fiduciary duty by the adviser upon the suing shareholder, the court interpreted this language to require exclusively, proof by the plaintiff that the advisory fee was excessive. Thus, before examining whether full disclosure had been made to

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* See, also Papilsky v. Berndt, [1976-1977 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶95,627 (S.D.N.Y. 1976).

the trustees concerning the benefits accruing to the adviser and its affiliates, the Court of Appeals plowed headlong into a determination of whether petitioner had proven that the advisory fee was unfair. Only after having found that there was insufficient proof that the advisory fee was excessive, did the court examine the disclosure made to the trustees.*

As noted above, the Second Circuit found this disclosure to be inadequate. In fact, the court even "advised" the independent trustees to "initiate studies" to determine the "fall-out

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* A non-excessive fee, petitioner submits, must still be disclosed. In this case, irrespective of fairness, disclosure would have been material. Fund shareholders were required to choose, blindly, between alleged luxury services rendered by the broker, costing up to $9.74 per transaction and services by the Bank obtaining the same essential result, costing $.15.

benefits" which the adviser had failed to disclose. However, since the court had previously found that petitioner had failed to prove that the advisory fee was excessive, it found that proof of this lack of complete disclosure was not proof of a breach of the adviser's fiduciary duty.

Accordingly, the result of the Second Circuit's decision is to negate a protection which had previously been granted by the courts to shareholders of mutual funds. Failure of the adviser to make full disclosure to the fund's independent directors, which prior to the enactment of §36(b) had been held to be a breach of fiduciary duty, is no longer actionable. Moreover, the burden of making known all available facts is no longer placed upon the adviser, but upon the independent trustees. Petitioner submits that this result not only defies

reality, but flies in the face of Congressional intent.

To begin with, although, as this Court has observed, the primary responsibility of protecting shareholder interests lies with the independent trustees,* it has been recognized that independent directors cannot perform their "watchdog" function without complete disclosure by the adviser. "[I]ndependent directors can perform their function under the Act only when they exercise informed discretion, and the responsibility for keeping the independent directors informed lies with management, i.e., the investment adviser and interested directors. See, e.g., 15 U.S.C. §80a-15(c)."**

* Burks v. Lasker, 441 U.S. 471 (1979).

** Tannenbaum v. Zeller, 552 F.2d 402, 417-418 (2d Cir.), cert. denied, 434 U.S. 934 (1977).

This "responsibility" is placed upon the investment adviser, because it is unrealistic to expect funds and their independent directors to ferret out necessary information. Most funds are mere "shells",* and their independent directors are not full time employees. Moreover, their resources are limited and activities or experience are generally not primarily connected with the special and often technical problems of fund operation.** Accordingly, it defies not only the clear intent of the Act, but also common sense, to shift the responsibility for insuring informed decisions by the Fund's board, from the adviser, now allowed to remain silent, to the independent directors, now

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* Galfand, supra, at 808.

** Tannenbaum, supra, at 418.

required to engage actively, in investigation and research.

Accordingly, the decision of the Second Circuit in the instant action, represents a regressive step in the law. Whereas Congress, with the passage of §§15(c) and 36(b), evidenced its dissatisfaction with the courts' prior interpretation of the Act, the Court of Appeals has determined that these two sections vitiate those very protections which Congress had decided were not enough. The decision of the Second Circuit is thus, clearly wrong, and should be reversed.

III. THE DECISION OF THE SECOND CIRCUIT ELIMINATES THE PROTECTIONS AFFORDED SHAREHOLDERS BY THE FIDUCIARY DUTY OF FULL DISCLOSURE.

As noted, supra, the Second Circuit's interpretation of §36(b) concerning disclosure to the trustees served to vitiate prior protections which had been

accorded to mutual funds. To an even greater degree, that court's decision with respect to the disclosure to shareholders required by §36(b), effectively eliminated other protections. As in the case of the trustees, this determination contravenes express Congressional intent, as well as judicial decisions interpreting the duty owed, prior to the enactment of §36(b), by the adviser to fund shareholders. It is, petitioner submits, wrong as a matter of law.

That shareholder disclosure is one of the paramount concerns of the Investment Company Act is clearly evidenced in the Act's preamble which states that "the <u>national public interest and the interest of investors are adversely affected</u>:

> "[w]hen investors purchase, pay for, exchange, receive dividends upon, vote, refrain from voting,

> sell, or surrender securities issued by investment companies without adequate, accurate, and explicit information, fairly presented, concerning the character of such securities and the circumstances, policies, and financial responsibility of such companies and their management;"*

Accordingly, in lawsuits instituted prior to §36(b), the courts held that the express policy of the Act mandated that disclosure to the shareholders be equivalent to that made to the trustees. Said the Second Circuit in <u>Tannenbaum</u> v. <u>Zeller</u>:

> "Despite the repeated and extensive disclosures to the independent directors about recapture, the subject was never presented to the shareholders until 1972. This contravened the policy of the Investment Company Act as declared in its preamble..."**

In the instant case, the Court of Appeals, interpreting the fiduciary

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* 15 U.S.C. §80a-1(b).

** 552 F.2d 434.

duty imposed by §36(b), reached a contrary decision. Stated the court:

> "[T]he Fund stockholders, before approving the management agreement between the Manager and the Fund, were made aware through proxy materials that the non-affiliated Fund trustees, who were the shareholders' watchdog representatives, Burks v. Lasker, 441 U.S. 471, 484-85 (1979), had considered extensive relevant information before continuing in effect the Fund's agreement with the Manager." Since the trustees have the primary responsibility under the Act, §36(b) does not require that the Fund shareholders be furnished with additional information over and above that provided."*

This holding effectively eviscerates the fiduciary standard which Congress plainly intended to impose. It is an elementary principle of law that a fiduciary has a two-fold duty with respect to his *cestui* when the fiduciary seeks to enter into a self-dealing

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* Second Circuit's Slip Opinion, p. 591 (A 23).

transaction: fair-dealing and full disclosure.* The Second Circuit in this case, however, created a two-tiered approach to disclosure of material information under §36(b), which leaves the shareholders of the Fund, whom Congress intended to be the principal beneficiaries of §36(b), in the dark, completely bereft of the information necessary to exercise any independent judgment on the issues before them for a vote. While Congress may have intended independent trustees to be "watchdogs" for the shareholders, it certainly did not intend to remove the ultimate power to pass upon the issues relating to compensation from the shareholders of the Fund, or that such power could

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* Restatement (Second) Trusts §170.

be effectively exercised without fully informed consent.

As this Court recognized in Burks v. Lasker,* an investment company is a creature of state law. It would be absurd to argue, under general corporate law or, indeed, the general federal securities statutes relating to disclosure under the Securities Exchange Act of 1934, that in a self-dealing transaction approved by the directors, disclosure to the shareholders that the independent directors had approved a transaction after "consider[ation] of extensive relevant information", would be sufficient. As one state court put it, in the context of a corporate self-dealing transaction, approved by the board of a controlled corporation, a corporate fiduciary owes a duty of "complete

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* Supra.

candor" to the shareholders under the common law. That standard of "completeness, not adequacy [which] is both the norm and the mandate"* under state law, is under federal statutes, at least as high. As this Court recently stated:

> "[A]n important purpose of the federal securities statutes was to rectify perceived deficiencies in the available common law protections by establishing higher standards of conduct in the securities industry."**

Under the federal securities laws, the SEC has sought to give more definite contours to the disclosure duties of corporate fiduciaries, for example, promulgating Rules 13e-3 and 4, governing disclosure in certain self-dealing transactions. Such rules require

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* Lynch v. Vickers Energy Corp., 383 A.2d 278, 281 (Del. Supr. Ct. 1978). (Emphasis added).

** Herman & MacLean v. Huddleston, ___ U.S. ___, 103 S. Ct. 683, 691 (1983).

extensive and detailed exposure of the facts to the shareholders, themselves, despite the necessity of prior director approval. The general securities laws, were, however, deemed insufficient protection for investment company shareholders, and the more stringent and pervasive Investment Company Act was enacted.* When the original provisions of the Investment Company Act proved inadequate to deal with the problem of excessive advisory fees, Congress adopted §36(b) and the attendant amendments to the Act in 1970.** In light of the clear Congressional intent and its substantial efforts in furtherance thereof, to permit a lesser standard of

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* See §1(a)(1)-(8) of the Act; 1 Loss, Securities Regulation (2d Ed. 1961), pp. 144, 146-147.

** See e.g., S. Rep. No. 184, 91st Cong., 1st Sess. (1969).

disclosure to shareholders of investment companies than that mandated under the common law or the 1934 Act, would be a paradoxical and dangerous anomaly which should not be allowed by this Court.

CONCLUSION

For the reasons set forth above, the instant petition should be granted.

Dated: New York, New York
March 3, 1983

Respectfully submitted,

SIDNEY B. SILVERMAN
Attorney for Petitioner
135 East 36th Street
New York, New York 10016

Of Counsel:

Joan T. Harnes
Martin H. Olesh
John F. Harnes
Silverman & Harnes

APPENDIX TO PETITION FOR CERTIORARI

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UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

Nos. 11, 14—August Term, 1982

(Argued September 15, 1982

Decided December 3, 1982)

Docket Nos. 82-7142, 82-7074

IRVING L. GARTENBERG,

Plaintiff-Appellant,

—against—

MERRILL LYNCH ASSET MANAGEMENT, INC., MERRILL LYNCH, PIERCE, FENNER AND SMITH, INC., and MERRILL LYNCH READY ASSETS TRUST,

Defendants-Appellees.

SIMONE C. ANDRE,

Plaintiff-Appellant,

—against—

MERRILL LYNCH READY ASSETS TRUST, and MERRILL LYNCH ASSET MANAGEMENT, INC.,

Defendants-Appellees.

Before:

MANSFIELD, VAN GRAAFEILAND and NEWMAN,
Circuit Judges.

Appeal from a judgment of the Southern District of New York, Milton Pollack, *Judge*, dismissing after a non-jury trial consolidated stockholders' derivative suits claiming that a money market fund affiliated with Merrill Lynch & Co. had been caused to pay excessive management and advisory fees to another Merrill Lynch affiliate in violation of § 36(b) of the Investment Company Act, 15 U.S.C. § 80a-35(b).

Affirmed.

STANLEY M. GROSSMAN, ESQ., New York, NY (Stephen P. Hoffman, Esq., Bruce G. Stumpf, Esq., Pomerantz Levy Haudek & Block, New York, NY, of counsel), *for Appellant Gartenberg.*

SIDNEY B. SILVERMAN, ESQ., New York, NY, *for Appellant Andre.*

JAMES K. MANNING, ESQ., New York, NY, (James B. May, Esq., A. Robert Pietrzak, Esq., Kent E. Daiber, Esq., Brown, Wood, Ivey, Mitchell & Petty, New York, NY, of counsel), *for Appellee Merrill Lynch Ready Assets Trust.*

William P. Rogers, Esq., New York, NY, (Stanley Godofsky, Esq., James N. Benedict, Esq., Anne Elizabeth Fontaine, Esq., Rogers & Wells, New York, NY, of counsel), *for Appellees Merrill Lynch Asset Management, Inc. and Merrill Lynch, Pierce, Fenner & Smith Incorporated.*

Mansfield, *Circuit Judge*:

Irving L. Gartenberg and Simone C. Andre, two shareholders of the Merrill Lynch Ready Assets Trust, a money market fund (the "Fund"), appeal from a judgment of the Southern District of New York, Milton Pollack, *Judge*, entered after a non-jury trial, dismissing their consolidated derivative actions against the Fund and its affiliates, Merrill Lynch Asset Management, Inc., the adviser and manager of the Fund (the "Manager") and Merrill Lynch, Pierce, Fenner & Smith, Inc. (the "Broker"). The plaintiffs claimed violations of §36(b) of the Investment Company Act of 1940, 15 U.S.C. §80a-35(b) (the "Act").[1] 528 F. Supp. 1038, 1040. The principal

[1] Section 36(b) provides in pertinent part:

"§ 80a-35.*Breach of fiduciary duty—Civil actions by Commission; jurisdiction; allegations; injunctive or other relief*

* * * * *

Compensation or payments as basis of fiduciary duty; civil actions by Commission or security holder; burden of proof; judicial consideration of director or shareholder approval; persons liable; extent of liability; exempted transactions; jurisdiction; finding restriction

(b) For the purposes of this sub-section, the investment adviser of a registered investment company shall be deemed to have a fiduciary duty with respect to the receipt of compensation for

claim is that the fees paid by the Fund to the Manager for various services, including investment advice and processing of daily orders of the Fund's shareholders, were so disproportionately large as to constitute a breach of fiduciary duty in violation of §36(b). We affirm the judgment dismissing the complaint.

Since the facts are fully set forth in detail in Judge Pollack's opinion, 528 F. Supp. 1038, only a brief summary here is necessary. The Fund, organized in 1975 as a no-load, diversified, open-end investment company, invests in short-term money market securities expected to pay the highest current income consistent with preservation of capital and maintenance of liquidity, such as short-term securities of the U.S. Government or its agen-

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services, or of payments of a material nature, paid by such registered investment company, or by the security holders thereof, to such investment adviser or any affiliated person of such investment adviser. An action may be brought under this subsection by the Commission, or by a security holder of such registered investment company on behalf of such company, against such investment adviser, or any affiliated person of such investment adviser, or any other person enumerated in subsection (a) of this section who has a fiduciary duty concerning such compensation or payments, for breach of fiduciary duty in respect of such compensation or payments paid by such registered investment company or by the security holders thereof to such investment adviser or person. With respect to any such action the following provisions shall apply:

"(1) It shall not be necessary to allege or prove that any defendant engaged in personal misconduct, and the plaintiff shall have the burden of proving a breach of fiduciary duty.

"(2) In any such action approval by the board of directors of such investment company of such compensation or payments, or of contracts or other arrangements providing for such compensation or payments, and ratification or approval of such compensation or payments, or of contracts or other arrangements providing for such compensation or payments, by the shareholders of such investment company, shall be given such consideration by the court as is deemed appropriate under all the circumstances.

This Circuit has recently held that the demand requirement of F.R.Civ.P. 23.1 does not apply to lawsuits brought under § 36(b). See *Fox v. Reich & Tang, Inc.*, No. 82-7296 (2d Cir. Oct. 26, 1982).

cies, bank certificates of deposit, and commercial paper. An investor may purchase and redeem shares of the Fund without any charges or penalties. There is a daily declaration of dividends, reflecting the net income of the Fund's portfolio. As the district court noted, the purchaser's investment in the Fund is more like a bank account than the traditional investment in securities. Idle money can be invested in the Fund for as little as a day and put to work earning interest. The ease of entrance and egress for the investor, coupled with the ability to share in high yields which the modest investor could not obtain through a bank deposit and might not be able to realize alone, has with the rise (until recently) of interest rates attracted an increasing number of investors. As a result the size of the Fund increased enormously over a few years, from $288 million in April 1977 to over $19 billion as of September 1981.

The Fund has an 8-person Board of Trustees, of whom 2 are interested and 6 are independent and unaffiliated. The operations of the Fund are conducted by the Manager, which provides the Fund with office space and facilities, administrative staff, equipment, portfolio management, compliance with SEC and state record-keeping and reporting requirements, and services to Fund shareholders. For the processing of approximately 80% of the purchases and redemptions of shares of the Fund the Manager uses the Broker, another Merrill Lynch affiliate, which is the largest registered broker-dealer in the United States, with 408 domestic offices located in numerous cities and towns, in which more than 7,000 account executives are located. In addition, the Manager uses the vast facilities of the Merrill Lynch organization and its affiliates to render special services to the Fund. For example, Merrill Lynch Economics, Inc. provides

economic research and forecasting services while Merrill Lynch Government Securities, Inc. provides expertise with respect to U.S. government and agency securities. A customer located anywhere in the United States can call the nearest office of the Broker or the Bank of New York, the Fund's custodian and transfer agent, order the purchase or redemption without charge of shares of the Fund, and through use of wires and computers the transaction will be carried out immediately. An average of 30,000 such orders are processed daily by the Broker's large organization.

Under the foregoing management the Fund has performed reasonably well in terms of average percentage yields for its shareholders. Its average percentage yields from 1978 through 1980 were slightly above the average for all similar funds. In 1980 it ranked 37th out of 76 money funds in terms of yield.

For all of these services the Manager charges the Fund an advisory fee based on a percentage of the average daily value of the Fund's net assets. The fee rate is graduated downward as the Fund's total assets increase in value. Since 1979 the schedule called for payment of 0.50% (1/2 of 1%) of the Fund's average daily value of net assets under $500 million and for various intermediate percentages as the value of the net assets increases down to 0.275% for assets in excess of $2.5 billion, resulting in an effective rate of 0.288%. This schedule is the product of a series of negotiations by the 6 independent Fund Trustees with the Manager over the period from 1977 to 1979, which resulted in reductions in the effective rate as the Fund grew in size.

Three studies were made at the Fund's instance to determine the estimated cost of the processing services provided by the Broker through the Manager to the Fund,

two by the Merrill Lynch organization's internal accounting staff and one by the independent accounting firm of Peat, Marwick, Mitchell & Co. ("PMM"). The estimates ranged from $2.02 to $7.50 per Fund order. The earlier internal study which produced the lowest figure did so mainly because it used a modified "incremental" cost method of accounting, based on the assumption that most costs would have been incurred by the Broker even if it had processed no Fund orders. By the time the PMM study was conducted in late 1979, however, modified full cost accounting methods were used for the reason that Fund orders represented a sizeable proportion of all business processed by the Broker; indeed, by April 1981 Fund orders accounted for 37% of all Broker business, necessitating the hiring by the Broker of close to 3,000 non-sales personnel. Had the Manager been required to reimburse the Broker for these costs instead of their being absorbed by the Broker as another Merrill Lynch affiliate, the Broker's net profit after taxes would have been greatly reduced, resulting in a figure ranging from a 38.4% profit to a substantial loss depending on which cost accounting study was used. In 1980, for instance, the last calendar year for which full figures are available, the Manager's fee was slightly over $33 million on the Fund's average net assets of $11.16 billion. Based on the volume of orders generated by 675,324 purchasers, the Broker's processing costs, estimated according to the PMM study, were so large that the Manager suffered a loss during 1980. 528 F. Supp. at 1053-54.

Judge Pollack, construing the legislative history of the Act, decided that the standard for determining whether the Manager had been guilty of a breach of fiduciary duty in violation of §36(b) was not whether its fees were "reasonable" as urged by plaintiffs but whether they were

unfair to the Fund and shareholders, which was to be determined by reference to the nature, quality and extent of the manager's services to the Fund, the money market fund industry practice and level of management fees, and to a lesser extent the Manager's net earnings as a result of providing the services. After reviewing the evidence and appraising the live witnesses who testified, he concluded that the compensation paid to the Manager was fair. *Id.* at 1055. The package of services described above was found to be extensive and valuable, providing Fund customers with the vast facilities of the Merrill Lynch organization, which were not available to non-Merrill Lynch funds.

The Manager's fee schedule was found by Judge Pollack to "bear a fair relation to the subject matter from which they are derived". *Id.* at 1068. He further found that "the total fee was fair to the Fund" after taking into consideration the nature and extent of the services, the fees charged by other advisors to other money market funds, the overall cost to the Merrill Lynch organization of providing the services, and the fee schedule's allowance for economies of scale by reducing the rate as the Fund's net assets increased. *Id.* at 1055. Judge Pollack also gave weight to the process by which the 6 noninterested trustees of the Fund approved of its management agreement with the Manager. The trustees, who were represented by capable independent counsel, were found to be competent, independent and conscientious in the performance of their duties. They were furnished with sufficient information to evaluate the contract. They thoroughly reviewed and weighed all facts pertinent to the fee, many of which are now part of the record, before approving the Manager's fee after negotiations.

The district court rejected plaintiffs' argument that in determining the fairness of the Manager's compensation the court must take into account as an offset to the Manager's fee the value to the Merrill Lynch organization of "fall-out" business generated by Fund customers who, after opening up a no-charge Fund account, transact other financial business with the Merrill Lynch Broker, such as purchases of stocks and bonds, for which the customer is charged a fee or commission. Thirty-eight percent of new Fund customers for the third quarter of 1979 transacted some non-Fund business through the Broker by January 1980. The fall-out benefit argument was rejected on the ground that any such offset could not be measured since it could not be established with certainty and without heavy expense what portion of the increase in brokerage business would have gone to the Broker without regard to the Fund. Judge Pollack further reasoned that the idea of an offset lacked logic since the customer would in any event have to pay a brokerage fee on non-Fund business. The possible benefit to the Merrill Lynch organization from a "float" resulting from its having the use of redemption funds before paying them to the redeeming Fund customer was found unpersuasive since it was obvious to all concerned. Plaintiffs' claim that there was unnecessary duplication in the Manager's services based on the Bank of New York's obligation to perform them was rejected for lack of proof.

The district court further found that an adequate disclosure of the pertinent facts needed to determine the fairness of the Manager's fee had been made to the Fund's trustee and shareholders.

DISCUSSION

Section 36(b) of the Investment Act of 1940, 15 U.S.C. §80a-35(b), which governs this case, provides that "the investment adviser of a registered investment company shall be deemed to have a fiduciary duty with respect to the receipt of compensation for services" paid by the investment company or its security holders and that in an action by a security holder on behalf of the investment company against the adviser or affiliate "[i]t shall not be necessary to allege or prove that any defendant engaged in personal misconduct" but "the plaintiff shall have the burden of proving a breach of fiduciary duty."

Appellants contend that the district court erred in rejecting a "reasonableness" standard for determining whether the Manager performed its "fiduciary duty" in compliance with §36(b). They further urge that the district court erred in relying primarily, in determining whether there was a breach of fiduciary duty, on other money market funds' level of management fees and on the Broker's costs. They argue that since each investment company fund is a captive of its manager, from which it cannot as a practical matter divorce itself, and since there is no possibility that a competitor will take the fund's business from its manager by offering a lower rate, the manager sets its own fee and the fund has no practical alternative but to pay it. It is contended that the test should therefore be what rate would have resulted from arm's-length negotiations in light of the services to be rendered. Appellants further contend that under this standard the fee in this case would have been substantially lower because of economies of scale, the Fund's massive bargaining power as the largest fund in history, and the Broker's duplication of services which the Bank of New

York was already required to render. In short it is argued that a fee percentage which may have been reasonable when the Fund was freshly-launched became unreasonable when the Fund grew to its present huge size. See, e.g., *Fogel v. Chestnutt*, 668 F.2d 100, 111 (2d Cir. 1981), *cert. denied*, 51 U.S.L.W. 3254 (Oct. 5, 1982).

In support of their advocacy of a "reasonableness" standard as the test by which a fiduciary's conduct under §36(b) should be governed, appellants point to excerpts from the Act's tortuous legislative history, just as the district court relied on other portions of the same history apparently rejecting that criterion in favor of a "breach of fiduciary duty" standard. The legislative history contains statements of legislators and legislative reports pointing in both directions. Bills introduced in 1967 and 1968, which would have imposed a "reasonableness" test, failed of passage. See H.R. 9510, H.R. 9511, and S. 1659, 90th Cong., 1st Sess. (1967) and S. 3724, 90th Cong., 2d Sess. (1968). When the mutual fund industry objected to this standard, a bill (S. 2224) was introduced in 1969 containing §36(b) in its present form, which was enacted in 1970. The Senate Report on the bill and the House Committee Report accompanying the companion bill do not define the term "fiduciary duty" as used in the bill or how it was to be distinguished from the term "reasonable" that had been used in predecessor bills. See *Investment Company Amendments Act of 1970*, S. Rep. No. 91-184, 91st Cong., 2d Sess. (1970), reprinted in [1970] U.S. Code Cong. & Ad. News 4897, and *Investment Company Amendments Act of 1970*, H.R. Rep. No. 91-1382, 91st Cong., 2d Sess. (1970). The Senate Report does state that an adviser-manager would not be precluded from earning a profit on services provided by it to a fund, that a "cost-plus" type of contract is not re-

quired, and that the court is not authorized "to substitute its business judgment for that of a mutual fund's board of directors in the area of management fees," *id.* at 4902-03. On the other hand, the same Report states that a "corporate waste" standard would be "unduly restrictive," [1970] U.S. Code Cong. & Ad. News at 4901, and Congressman Moss, Chairman of the Committee on Interstate and Foreign Commerce, who was one of the chief sponsors of §36(b), explained to the House that "[t]his [bill], by imposition of the fiduciary duty, would in effect require a standard of reasonableness in the charges," 116 Cong. Rec. 33281 (Sept. 23, 1970). Thus there was no attempt to set forth a definitive test by which observance or breach of fiduciary duty was to be determined.

In short, the legislative history of §36(b) indicates that the substitution of the term "fiduciary duty" for "reasonable," while possibly intended to modify the standard somewhat, was a more semantical than substantive compromise, shifting the focus slightly from the fund directors to the conduct of the investment adviser-manager. As the district court and all parties seem to recognize, the test is essentially whether the fee schedule represents a charge within the range of what would have been negotiated at arm's-length in the light of all of the surrounding circumstances. (Gartenberg Br. 15, 23, 24; Merrill Lynch Br. 27; Judge Pollack's opinion, 528 F. Supp. at 1047.) The Senate recognized that as a practical matter the usual arm's length bargaining between strangers does not occur between an adviser and the fund, stating:

> "Since a typical fund is organized by its investment adviser which provides it with almost all management services and because its shares are bought by investors who rely on that service, a mutual fund

> cannot, as a practical matter sever its relationship with the adviser. Therefore, the forces of arm's-length bargaining do not work in the mutual fund industry in the same manner as they do in other sectors of the American economy." S. Rep. No. 91-184, *supra*, [1970] U.S. Code Cong. & Ad. News at 4901.

To be guilty of a violation of §36(b), therefore, the adviser manager must charge a fee that is so disproportionately large that it bears no reasonable relationship to the services rendered and could not have been the product of arm's-length bargaining. *Fogel v. Chestnutt, supra*, 668 F.2d at 112 (2d Cir. 1981). *cert. denied*, 51 U.S.L.W. 3254 (Oct. 5, 1982); *In re Gartenberg*, 636 F.2d 16, 18 (2d Cir. 1980), *cert. denied*, 451 U.S. 910 (1981). To make this determination all pertinent facts must be weighed.

We disagree with the district court's suggestions that the principal factor to be considered in evaluating a fee's fairness is the price charged by other similar advisers to funds managed by them, that the "price charged by advisers to those funds establishes the free and open market level for fiduciary compensation," that the "market price . . . serves as a standard to test the fairness of the investment advisory fee," and that a fee is fair if it "is in harmony with the broad and prevailing market choice available to the investor," 528 F. Supp. at 1049, 1067-68. Competition between money market funds for shareholder business does not support an inference that competition must therefore also exist between adviser-managers for fund business. The former may be vigorous even though the latter is virtually non-existent. Each is governed by different forces. Reliance on prevailing industry advisory fees will not satisfy §36(b).

We do not suggest that rates charged by other adviser-managers to other similar funds are not a factor to be taken into account. Indeed, to the extent that other managers have tended "to reduce their effective charges as the fund grows in size," the Senate Committee noted that such a reduction represents "the best industry practice [which] will provide a guide," S. Rep. No. 91-184, *supra*, [1970] U.S. Code Cong. & Ad. News at 4902. However, the existence in most cases of an unseverable relationship between the adviser-manager and the fund it services tends to weaken the weight to be given to rates charged by advisers of other similar funds. Report of the Securities and Exchange Commission on the Public Policy Implications of Investment Company Growth, H.R. Rep. No. 2337, 89th Cong., 2d Sess. (1966) 131, 148.[2] A

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2 The following statement in the Report of the Securities and Exchange Commission on The Public Policy Implications of Investment Company Growth, while directed to mutual funds, is pertinent to money market funds:

"It has been the Commission's experience in the administration of the Act that in general the unaffiliated directors have not been in a position to secure changes in the level of advisory fee rates in the mutual fund industry. In most instances the adviser serves as, or is closely affiliated with, the fund's principal underwriter which maintains a distributing organization for the fund's shares. The organization that has developed over a period of years to manage the fund's portfolio and to furnish it with some, and in certain cases virtually all, of the nonadvisory services necessary to its operation belongs to the adviser and not to the fund. Indeed, in some cases all of the fund's records are maintained by the fund's adviser. Although the unaffiliated directors under State law have an unqualified right of access to these records, the adviser, as a practical matter, is in a position to seriously hamper any employment of that right which might interfere with or threaten the adviser's operation of or control over the fund.

"Thus, negotiations between the unaffiliated directors and fund advisers over advisory fees would lack an essential element of arm's-length bargaining—the freedom to terminate the negotiations and to bargain with other parties for the same services. In view of the fund's dependence on its existing adviser and the fact that many shareholders may have invested in the fund on the strength of the

fund cannot move easily from one adviser-manager to another. Therefore "investment advisers seldom, if ever, compete with each other for advisory contracts with mutual funds." *Id.* at 126.

One reason why fund competition for shareholder business does not lead to competition between adviser-managers for fund business is the relative insignificance of the adviser's fee to each shareholder. The fund customer's shares of the advisory fee is usually too small a factor to lead him to invest in one fund rather than in another or to monitor adviser-manager's fees. "Cost reductions in the form of lower advisory fees . . . do not figure significantly in the battle for investor favor." *Id.* Hence money market funds do not generally advertise that their advisory fees may be lower than those charged by advisers to other funds. The disparity is competitively insignificant. In the present case, for instance, the alleged excessive Manager's fee amounts to $2.88 *a year* for each $1,000 invested. If rates charged by the many other advisers were an affirmative competitive criterion, there would be little purpose in §36(b). Congress, however, recognized that because of the potentially incestuous relationships between many advisers and their funds, other factors may be more important in determining whether a fee is so excessive as to constitute a "breach of fiduciary duty." These include the adviser-manager's cost in providing the service, the nature and quality of the service, the extent to which the adviser-manager realizes economies of scale as the fund grows larger, and the

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adviser's reputation, few unaffiliated directors would feel justified in replacing the adviser with a new and untested organization simply because of difficulty in obtaining a reduction in long-established fee rates which are customary in the industry." H.R. Rep. No. 2337, 89th Cong., 2d Sess. 131 (1966).

volume of orders which must be processed by the manager. The legislative history of §36(b) makes clear that Congress

> "intended that the court look at all the facts in connection with the determination and receipt of such compensation, including all services rendered to the fund or its shareholders and all compensation and payments received, in order to reach a decision as to whether the adviser has properly acted as a fiduciary in relation to such compensation." S. Rep. No. 91-184, *supra*, [1970] U.S. Code Cong. & Ad. News at 4910.

As the district court recognized, the expertise of the independent trustees of a fund, whether they are fully informed about all facts bearing on the adviser-manager's service and fee, and the extent of care and conscientiousness with which they perform their duties are important factors to be considered in deciding whether they and the adviser-manager are guilty of a breach of fiduciary duty in violation of §36(b). But even if the trustees of a fund endeavored to act in a responsible fashion, an adviser-manager's fee could be so disproportionately large as to amount to a breach of fiduciary duty in violation of §36(b). Moreover, an intent to defraud need not be proved to establish a violation. Section 36(b)(1), 15 U.S.C. §80a-35(b)(1), expressly relieves the plaintiffs of the necessity of alleging or proving that any defendant engaged in personal misconduct.

Nor do we subscribe to the district court's suggestion, 528 F. Supp. at 1044, that because §36(b) was adopted in response to public concern over fees charged to investors in front-end load equity funds, the standard for determining whether there has been a breach of duty in avoiding

excessive fees should be different or lower for managers of no-load money market funds, which are a recent, post-statute phenomenon. A potential for abuse of fiduciary relationship regarding fees charged for management and advisory services exists with respect to both types of fund since the adviser-manager's fee remains insignificant to each shareholder, whether or not a load factor inhibits redemption of shares.[3]

Application of the foregoing standards to this case confirms that plaintiffs have failed to meet their burden of proving that the fees charged by the Manager to the Fund were so excessive or unfair as to amount to a breach of fiduciary duty within the meaning of §36(b). There is no evidence that the services rendered by the Manager have not been of the highest quality, bringing to bear the expertise and facilities of the huge, far-flung Merrill Lynch organization. The average investor in the Fund, while not realizing the highest possible yield for his investment, has enjoyed a better-than-average return.

The substantial increase in the Manager's fee, from $1,578,476 in 1977 to $39,369,587 for the year ending June 1981, resulted from the tremendous increase in the size of the Fund, from $428 million to over $19 billion during the same period. This increase multiplied the number of customers, daily transactions and other activities which the Manager and the Merrill Lynch organiza-

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3 Appellants' argument that the lower fees charged by investment advisers to large pension funds should be used as a criterion for determining fair advisory fees for money market funds must also be rejected. The nature and extent of the services required by each type of fund differ sharply. As the district court recognized, the pension fund does not face the myriad of daily purchases and redemptions throughout the nation which must be handled by the Fund, in which a purchaser may invest for only a few days.

tion handled as part of the service for the fee, thereby increasing costs proportionately. The orders processed annually by the Manager for the Fund increased from 2,486,782 in 1979 to 6,096,537 for the 12-month period ending June 30, 1981. Appellants' contention that since the Manager's own administrative expenses did not increase proportionately during the period after 1978, its profit margin was 96% for the 12-month period ending September 30, 1981, is unrealistic and was properly rejected by the district court. Proceeding on the erroneous theory that only the administrative costs incurred by the Manager itself may be considered, appellants ignore the heavy costs incurred by other Merrill Lynch affiliates in processing the increased volume of purchases and redemptions of Fund shares which were under the Manager's guidance. Since the Manager and Broker were divisions of one economic unit, the district court was entitled to deduct these costs in calculating the Manager's net profits. To limit consideration to the Manager's own administrative expenses would be to exalt form over substance and disregard the expressed Congressional intent that "all the facts in connection with the determination and receipt of such compensation" be considered.

Although the court reduced the after-tax profits by determining the Manager's tax liability before deducting the processing costs, deduction of the costs before determining after-tax liability would nevertheless result in profits that could hardly be labelled so excessive as to constitute a breach of fiduciary duty. For instance, when processing costs are deducted before determining tax liability, the Manager's fee of $39,369,587 for the year ending June 30, 1981, would result in a 38.4% after-tax profit if the Fitz-Gerald estimate of processing costs were adopted, 9.8% after-tax profit under the Diemer estimate

and a $7.7 million loss under the PMM estimate.[4] No cost studies showing a higher after-tax profit were offered by appellants, who had the burden of proof. Moreover, after good-faith bargaining at arm's length between the 6 independent Fund trustees and the Manager, the latter's rate was graduated downward to reflect the economies

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[4] These percentages were arrived at by the following calculations:

	Using Fitz-Gerald Estimate of Processing Costs	*Using Diemer Estimate of Processing Costs*	*Using PMM Estimate of Processing Costs*
ADVISER'S Fee	$39,369,587	$39,369,587	$39,369,587
Less direct costs	1,567,847	1,567,847	1,567,847
Less processing costs	10,534,805	30,848,477	45,541,131
PRE-TAX PROFIT (LOSS)	27,266,935	6,953,263	(7,739,391)
Less tax at 44.5%	12,133,786	3,094,202	— —
AFTER-TAX PROFIT	15,133,149	3,859,061	— —
PERCENTAGE OF ADVISER'S FEE THAT GOES TO AFTER-TAX PROFIT	38.4%	9.8%	— —

See 528 F. Supp. at 1038 for the source of the cost figures. Merrill Lynch & Co. allocates its overall tax liability to its subsidiaries, including the Fund; the overall Merrill Lynch 1980 tax rate of 44.5% has therefore been applied to all of these profit figures.

Appellants' contention that the PMM cost study improperly included selling or distribution expenses that may not be taken into consideration in determining whether the Manager's fee was excessive, see SEC Rule 12b-1, 17 C.F.R. §270.12b-1, must be rejected, since the latter is limited to promotional expenses (e.g., advertising, sales literature) designed to create new sales of no benefit to existing shareholders and the record reveals no such promotion of Fund sales by the Merrill Lynch organization.

that might be realized from the increase in value of the net assets. In view of these circumstances we cannot label clearly erroneous the district court's finding that no breach of fiduciary duty was shown.

Faced with these facts appellants respond that the Fund and the Manager, by having the processing of purchasing and redemption orders done by the Broker, were wastefully duplicating the services of its transfer agent, the Bank of New York, which was obligated, among its other duties, to accept Fund purchase and redemption orders. For these services the Bank of New York charged the Fund $13 per shareholder's account per year regardless of the number of transactions. For its services as transfer agent in the year 1980 the bank received $12,404,444 from the Fund. The services rendered to shareholders by the Merrill Lynch organization, however, greatly exceeded those that could be furnished by the Bank of New York, which performs the duties required of it as Transfer Agent under its agreement with the Fund at only one main office located in New York City. Purchasers of shares are attracted to the Fund by the convenience and flexibility of the huge Merrill Lynch Broker's organization with its network of over 400 offices and 7,000 account executives in the United States alone. A simple telephone call or visit by a Fund customer to an account executive in the nearest Merrill Lynch branch office is all that is needed to effectuate in-person Fund services. Most of the transactions through the bank, on the other hand, apparently are effectuated by mail or wire and involve other complications. Thus, although customers could open Fund accounts through the Bank of New York, approximately 80% of the 1980 Fund purchase and redemption orders were initiated through the Broker and approximately 99% of the half-million new Fund ac-

counts in 1980 were opened through the Broker's branch office system. If the Fund did not have the Broker's network to provide the in-person services sought by customers and to handle the millions of orders executed annually but instead were restricted to use of the limited facilities of the Bank of New York, it would be unable to function effectively at its present high-volume level. There is no evidence that the Bank of New York is prepared to expand its location and services to the level provided by the Broker.

A more serious problem is posed by appellants' claim that in negotiating the Manager's fee the Merrill Lynch Fund and Manager failed to take into account that the Merrill Lynch Broker has gained large "fall-out" financial benefits annually in the form of commissions on non-Fund securities business generated by Fund customers and interest income on funds (known as the "float") held by the Broker from the date when a redemption check is issued by the Fund to its customer until the date it clears. If these benefits were taken into consideration, the argument goes, they would constitute a very substantial offset calling for a lower fee to the Manager than that paid by the Fund. Therefore, appellants contend, the Manager and the Fund, by failing to offset these benefits, were guilty of a breach of fiduciary duty in violation of §36(b).

The record reveals that a large percentage of persons who opened accounts with the Broker as Fund customers, e.g., some 38% of those who opened such accounts in the third quarter of 1979, later did some non-Fund business with Merril Lynch, generating commissions for the Broker. Robert Diemer, the Broker's Director of Financial Services, testified that processing of Fund accounts helped to attract new equity security business which

increased the Broker's commission revenue. These benefits to an affiliate in the Merrill Lynch organization, to the extent quantifiable, should be taken into account in determining whether the Manager's fee meets the standard of §36(b). Although the independent trustees may have been aware of these benefits, we are unpersuaded by the district court's suggestion that they cannot be measured or quantified because of inability to determine "whether customers who normally did an above-average level of brokerage business also tended to have Fund accounts" or to ascertain "what portion of the [increased brokerage business] would . . . have gone to Merrill Lynch in any event." It would not seem impossible, through use of today's sophisticated computer equipment and statistical techniques, to obtain estimates of such "fall-out" and "float benefits" which, while not precise, could be a factor of sufficient substance to give the Funds' trustees a sound basis for negotiating a lower Manager's fee. However, the burden was on appellants, not the defendants, to adduce evidence demonstrating that the benefits were so substantial that they rendered the Manager's fee so disproportionately large as to label its negotiation a "breach of fiduciary duty" within the meaning of §36(b). Since appellants failed to offer such evidence, the dismissal of their contention must be affirmed.

Since the district court properly took into consideration the fact that the Merrill Lynch organization's costs of processing Fund orders are substantial and the record fails to show that the Manager's profits were so disproportionately large as to amount to a breach of fiduciary duty, we find no merit in appellants' further argument that the Manager violated §36(b) by failing to disclose to the Fund's trustees relevant cost information and poten-

tial benefits. As Judge Pollack found, the Trustees were aware of or could obtain the essential facts needed to negotiate a reasonable fee. Similarly the Fund stockholders, before approving the management agreement between the Manager and the Fund, were made aware through proxy materials that the non-affiliated Fund trustees, who were the shareholders' watchdog representatives, *Burks v. Lasker*, 441 U.S. 471, 484-85 (1979), had considered extensive relevant information before continuing in effect the Fund's agreement with the Manager. Since the trustees have the primary responsibility under the Act, §36(b) does not require that the Fund shareholders be furnished with additional information over and above that provided.

Our affirmance is not a holding that the fee contract between the Fund and the Manager is fair and reasonable. We merely conclude that on this record appellants failed to prove by a preponderance of the evidence a breach of fiduciary duty. Whether a violation of §36(b) might be established through more probative evidence of (1) the Broker's processing costs, (2) the offsetting commission benefits realized by the Broker from non-Fund securities business generated by Fund accounts, and (3) the "float" interest income gained by the Broker from its method of handling payment on Fund redemptions, must therefore remain a matter of speculation. Indeed, the independent trustees of the Fund might well be advised, in the interests of Fund investors, to initiate such studies.

The only claim alleged by appellants in their complaints and tried to the district court was that defendants were guilty of breach of fiduciary duty by paying the Manager excessive compensation in violation of §36(b). Following trial and on this appeal appellants have sought to expand this claim to include charges that the defendants violated

other provisions of the Act, §§15(a)-(c) and 20(a), 15 U.S.C. §§80a-15(a)-(c) and 20(a).[5] Appellants' Proposed

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[5] "§ 80a-15. *Contracts of advisers and underwriters*

"(a) It shall be unlawful for any person to serve or act as investment adviser of a registered investment company, except pursuant to a written contract, which contract, whether with such registered company or with an investment adviser of such registered company, has been approved by the vote of a majority of the outstanding voting securities of such registered company, and—

(1) precisely describes all compensation to be paid thereunder;

(2) shall continue in effect for a period more than two years from the date of its execution, only so long as such continuance is specifically approved at least annually by the board of directors or by vote of a majority of the outstanding voting securities of such company;

(3) provides, in substance, that it may be terminated at any time, without the payment of any penalty, by the board of directors of such registered company or by vote of a majority of the outstanding voting securities of such company on not more than sixty days' written notice to the investment adviser; and

(4) provides, in substance, for its automatic termination in the event of its assignment.

"(b) It shall be unlawful for any principal underwriter for a registered open-end company to offer for sale, sell, or deliver after sale any security of which such company is the issuer, except pursuant to a written contract with such company, which contract—

(1) shall continue in effect for a period more than two years from the date of its execution, only so long as such continuance is specifically approved at least annually by the board of directors or by vote of a majority of the outstanding voting securities of such company; and

(2) provides, in substance, for its automatic termination in the event of its assignment.

"(c) In addition to the requirements of subsections (a) and (b) of this section, it shall be unlawful for any registered investment company having a board of directors to enter into, renew, or perform any contract or agreement, written or oral, whereby a person undertakes regularly to serve or act as investment adviser of or principal underwriter for such company, unless the terms of such contract or agreement and any renewal thereof have been approved by the vote of a majority of directors, who are not parties to such contract or agreement or interested persons of any such party, cast in person at a meeting called for the purpose of voting on such approval. It shall be the duty of the directors of a registered

Findings of Fact and Conclusions of Law, even after updating, did not refer to these additional alleged violations of other sections of the Act. The belated post-trial attempt to add these claims was apparently motivated by plaintiffs' desire to avoid the one-year statute of limitations applicable to actions under §36(b). We accordingly affirm the district court's dismissal of these purported aditional claims as not having been presented to the district court for adjudication. In any event, for the reasons already expressed by us and the additional reasons stated by the district court in its discussion of these additional claims "for the sake of completeness," 528 F. Supp. at 1066-67, they are meritless.

The judgment of the district court is affirmed.

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investment company to request and evaluate, and the duty of an investment adviser to such company to furnish, such information as may reasonably be necessary to evaluate the terms of any contract whereby a person undertakes regularly to serve or act as investment adviser of such company. . . ."

"§ 80a-20. *Proxies; voting trusts; circular ownership*

"(a) It shall be unlawful for any person, by use of the mails or any means or instrumentality of interstate commerce or otherwise, to solicit or to permit the use of his name to solicit any proxy or consent or authorization in respect of any security of which a registered investment company is the issuer in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors."

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

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IRVING L. GARTENBERG,

Plaintiff, : 79 Civ. 3123 (MP)

v.

MERRILL LYNCH ASSET MANAGEMENT, INC., MERRILL LYNCH, PIERCE, FENNER & SMITH INCORPORATED, and MERRILL LYNCH READY ASSETS TRUST,

Defendants.

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SIMONE C. ANDRE,

Plaintiff, : 79 Civ. 5726 (MP)

v.

MERRILL LYNCH READY ASSETS TRUST and MERRILL LYNCH ASSET MANAGEMENT, INC.,

Defendants.

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FINDINGS AND OPINION

APPEARANCES:

POMNERANTZ LEVY HAUDEK & BLOCK
Attorneys for Plaintiff Irving L. Gartenberg
295 Madison Avenue
New York, N.Y. 10017
By: Stanley M. Grossman, Esq.
Stephen P. Hoffman, Esq.
Bruce G. Stumpf, Esq.

SILVERMAN & HARNES
Attorneys for Plaintiff Simone C. Andre
135 East 36th Street
New York, N.Y. 10016
By: Sidney B. Silverman, Esq.
Joan T. Harnes, Esq.
Martin H. Olesh, Esq.

BROWN, WOOD, IVEY, MITCHELL & PETTY
Attorneys for Defendant Merrill Lynch Ready Assets Trust
One Liberty Plaza
New York, N.Y. 10006
By: James B. May, Esq.
James K. Manning, Esq.
A. Robert Pietrzak, Esq.

ROGERS & WELLS
Attorneys for Defendants Merrill Lynch Asset Management, Inc. and Merrill Lynch, Pierce, Fenner & Smith Incorporated
200 Park Avenue
New York, N.Y. 10166
By: William P. Rogers, Esq.
Stanley Godofsky, Esq.
James N. Benedict, Esq.
Anne D. Neal, Esq.

MILTON POLLACK, District Judge.

Milton Pollack, District Judge

Preliminary

Over 1,100,000 persons and institutions were at the time of trial herein shareholders in a money market fund whose net assets at that time exceeded \$19 billion, known as the "Merrill Lynch Ready Assets Trust" (the "Fund" hereafter). Two individual shareholders, Irving Gartenberg and Simone Andre, have brought this suit under Section 36(b) of the Investment Act of 1940, 15 U.S.C. Section 80-35(b) (the "Act") complaining of the size of the annual compensation paid to the Fund's Investment Adviser in 1980-81 under its percentage contract with the Fund. The fee paid to the Adviser, "Merrill Lynch Assets Management, Inc." ("MLAM" hereafter) is contingent on the average daily value of the net assets of the Fund during the period; the annual compensation amounted to

0.288% or slightly above 1/4 of one percent of those net assets.

The Gartenberg complaint names as defendants, i) the Fund, ii) MLAM, a wholly-owned subsidiary of Merrill Lynch & Co., Inc. ("Merrill Lynch"), which supplies the Fund with investment management, administration and required services, and iii) "Merrill, Lynch, Pierce, Fenner & Smith Incorporated" (MLPF&S) another wholly-owned subsidiary of Merrill Lynch, which processes the vast bulk of the daily orders of the Fund's shareholders. The Andre complaint names only the Fund and MLAM as defendants.

There is no claim by the plaintiffs that the shareholders individually did not receive their money's worth from MLAM, i.e., that the services supplied were not worth the fractional percentage attributable to the net assets they had

in the Fund. Rather, the plaintiffs claim that because of the size of the Fund, MLAM made too much money from the application of the agreed percentage.[1/]

As of December 31, 1980, plaintiff Gartenberg held 986 shares (valued at $1 per share) of the Fund and plaintiff Andre held 2,850 shares and they have continued to hold those shares together with additional shares received daily as dividends.[2/]

1/ The amount of the compensation at issue in these suits is the amount that MLAM has received during the year September 4, 1980 until September 4, 1981. This limitation is deriverd from the limitary period on the award of damages set by Section 36(b)(3) of the Act, 15 U.S.C. Sec. 80a-35(b)(1976). See Gartenberg v. Merrill Lynch, 79 Civ. 3123 (S.D.N.Y. Sept. 4, 1981) (granting plaintiffs' motion to amend and supplement their admittedly insufficient claim as of Sept. 4, 1981 on the basis of plaintiffs' said stipulation).

2/ On or about December 1, 1980, during the pendency of this suit, a new account in the Fund was opened for J.M. Gartenberg under the Uniform Gift to Minors Act, and on January 6, 1981 additional shares were purchased for the account.

The Fund and the Merrill Lynch organization

The Fund was organized in 1975 as an unincorporated business trust under the laws of Massachusetts and registered with the Securities and Exchange Commission ("SEC") as a diversified, open-end investment company. It is a no-load money market mutual fund (meaning that there is no cost to purchase its shares) and invests primarily in short-term money market securities.[3/]

The Fund's Board of Trustees is comprised of eight Trustees, two of whom are "interested persons" as defined in the Act. The six "non-interested" or "unaffiliated"

3/ E.g., short-term United States Government securities, Government agency securities, bank certificates of deposit and bankers acceptances; short-term corporate debt securities such as commercial paper and variable amount master demand notes; and repurchase and reverse repurchase agreements.

Trustees make up the Audit Committee of the Fund. The Fund has no employees of its own. Its business is conducted from the offices of MLAM as is the business of other Merrill Lynch investment companies.

MLAM, a Delaware corporation, has served as the Investment Adviser of the Fund since June 1976. MLAM also acts as the investment adviser for four other mutual funds sponsored by Merrill Lynch. MLAM selects the Fund's investments and trades in money market securities for the Fund's account. MLAM performs or provides the administrative and management services for the Fund and provides the Fund with office space and facilities, equipment and personnel. It imports the services of its affiliate, defendant MLPF&S, the brokerage subsidiary of Merrill Lynch, to process the principal volume of the huge number of daily orders of the Fund shareholders for the

deposit and withdrawal of money to and from the Fund. MLAM also provides investment management services to individuals and institutions. The services performed for the Fund by MLAM and its affiliates can be divided into three categories: portfolio management; general administrative services; and money market fund shareholder services.

The Merrill Lynch brokerage branch office system consists of 408 domestic offices in which its more than 7,000 account executives are located, all of whom are available to process shareholder orders and administer shareholder accounts for the Fund without any commission. An average of more than 30,000 shareholder orders *per day* are processed in that way by MLPF&S involving the purchase and redemption of shares of the Fund and other services. Much of the success of the Fund in terms of its

acceptance by shareholders can be attributed to the fulsome shareholder service provided by that system.

In making its investment decisions, MLAM has access to the advice and expertise of all Merrill Lynch affiliates, and particularly Merrill Lynch Economics, Inc., Merrill Lynch Government Securities, Inc. and MLPF&S. The first of these affiliates provides basic economic research and forecasting; the second is one of the largest dealers in United States Government securities and Government Agency securities; and MLPF&S is the largest registered broker-dealer in the United States and provides fundamental research on bank and other corporate issuers.

The compensation attributable to the individual shareholder for the services provided by MLAM and its affiliates was far below the cost of any available

alternative for similar service. The administrative services provided for the Fund by MLAM amply serve the Fund's requirements and go well beyond mere office matters. Substantial efforts are necessary to maintain compliance with SEC and state regulatory requirements, including record-keeping and reporting requirements. MLAM renders these services to the Fund. Additionally Merrill Lynch Funds Distributor, Inc. (MLFD), which is a 100% owned subsidiary of MLAM, acts as distributor of Fund shares and maintains a staffed answer-telephone for inquiries from shareholders. MLFD has waived its right to commissions on the sale of Fund shares.[4/]

4/ The agreement between the Fund and MLAM's wholly-owned subsidiary MLFD, permits the latter "to enter into selected dealer agreements with securities dealers of its choice." Pursuant to its contract with the Fund, MLFD has designated its affiliate, MLPF&S, as a dealer in Fund shares. MLPF&S has also waived commissions on the sale of Fund shares.

The Money Fund Industry and the Growth of the Fund

Money market funds make available to small investors and short term cash depositors substantially higher interest rates than are obtainable through bank deposits. They offer redeemable participations in terms of shares in a portfolio of securities. The first such fund was started in 1972.

The money market fund industry has experienced extraordinary growth in the last few years. New money market funds have been sprouting up regularly -- there is no difficulty in entering the field. In 1975, there were 32 money market funds. By 1978 there were 54 and today there are 139[4a/] such funds. The assets under management in all the

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4a/ N.Y. Times, Dec. 18, 1981, p. D9, at col. 4.

money market funds have likewise grown enormously and dramatically. In June 1978 there was a total of about $6.8 billion of assets in money market funds; today their assets total more than $185 billion -- a 25-fold growth. The Fund involved herein is by far the largest money market fund in existence.

The principal reason for the prodigious growth of the Fund under MLAM's supevision, from $100 million to over $19 billion in just a few years, has been the spectacular surge in interest rates and the availability of the Merrill Lynch system to cope with the processing services required -- to administer the dramatic growth of the Fund and to satisfy the daily orders and other demands of its shareholders. It was conceded by plaintiffs' expert that there is no adequate substitute readily

available for the Merrill Lynch system to handle the Fund. The enormous gap between interest rates paid by banks and money funds renders the Fund an attractive short-term investment for high daily income returns, in a medium available without any cost to the customer to buy or sell the investment, by easy means of deposits and withdrawals in every geographical area of the United States (and beyond), subject to simple check withdrawals, as frequently as desired by the shareholder, with relative security of the principal meanwhile.

The net asset value of shares of the Fund remains constant at $1 per share and net income (including realized and unrealized gains and losses of the Fund's portfolio) is credited daily to shareholder accounts in the form of dividend shares declared daily. Thus,

the fluctuations in the value of a shareholder's investment in the Fund are reflected in the number of shares held in the shareholder's account.

The deposits and withdrawals by participants in the Fund are somewhat euphemistically styled as purchases and sales of shares of the value of those deposits and withdrawals. In a very real sense, an account in a money market fund is more like a bank account than a traditional investment in securities; and unlike an equity stock investment or other types of securities. The funds in a money market fund are not tied up for a fixed or long time.

The Investment Advisory Agreement

The Fund commenced operations on February 18, 1975 as the "Lionel D. Edie Ready Assets Trust." The initial investment advisory agreement provided

for an advisory fee of 0.50% of the net average daily assets.[5/]

MLAM was formed in 1976 as the investment management subsidiary of Merrill Lynch so that a single Merrill Lynch company could utilize the vast resources of the entire Merrill Lynch organization in determining and achieving the specific investment objectives of institutional portfolios.

On April 29, 1976, the Fund Trustees approved the first investment advisory agreement with MLAM. It provided for a schedule of contingent advisory fees starting with an annual charge of 0.50% of the first $500 million of average

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5/ This initial agreement was with Edie Management Services, Inc. ("Edie"), not MLAM; in connection with the sale by Merrill Lynch of Edie's parent in 1976, a new investment advisory agreement was entered into between the Fund and the then newly-created MLAM.

daily net assets, and followed by reduced percentages at a series of breakpoints as the net assets of the Fund increased. At the time the net assets of the Fund were just over $100 million. In June 1976, MLAM began acting as investment advisor to the Fund pursuant to their first advisory agreement, and the name of the Fund was changed to the "Merrill Lynch Ready Assets Trust."

The following year, on April 28, 1977, the Trustees approved continuance of the same investment advisory agreement. The Fund's assets were then approximately $288 million. One year later the assets of the Fund had grown to approximately $750 million, and MLAM proposed a revised fee schedule that would have continued the 1977 rates at existing breakpoints but would have added an additional breakpoint providing

for an annual fee of 0.375% on assets in excess of $1 billion. The independent Trustees accepted MLAM's proposal to add a new breakpoint at the $1 billion level, but insisted on reducing the proposed fee rate to 0.425% and 0.375% on assets in excess of $500 million and $750 million respectively and to 0.35% at the new $1 billion level. Although MLAM was opposed to these revisions in its fee schedule, it accepted the Trustees' decision and on April 27, 1978, the Trustees approved an agreement containing the fee reductions as initiated by the independent Trustees.

During late 1978, the assets of the Fund increased substantially. On January 24, 1979, while the 1978 agreement was still in effect, MLAM again voluntarily reduced its fee by introducing two additional breakpoints at the $1.5

and $2 billion levels. These additional breakpoints reduced the advisory fee to 0.325% of assets over $1.5 billion and 0.30% of assets over $2 billion. At that time the Fund had net assets of approximately $2 billion.

The Fund continued to grow rapidly during 1979, and in May its assets reached $3.5 billion. On May 8, 1979, the Trustees approved an advisory agreement, which added yet another breakpoint at the $2.5 billion asset level.

The schedule of advisory fees payable to MLAM under the 1979 and subsequent agreements is set forth in the table below:

Portion of average daily value of net assets:	Advisory Fee
Not exceeding $500 million	0.50%
In excess of $500 million but not exceeding $750 million	0.425%

Portion of average daily value of net assets:	Advisory Fee
In excess of $750 million but not exceeding $1 billion	0.375%
In excess of $1 billion but not exceeding $1.5 billion	0.35%
In excess of $1.5 billion but not exceeding $2 billion	0.325%
In excess of $2 billion but not exceeding $2.5 billion	0.30%
In excess of $2.5 billion	0.275%

This fee schedule was reviewed and approved by the Trustees of the Fund for another year on April 24, 1980, when the size of the Fund was $9.8 billion, and again on May 7, 1981, when the size of the Fund was $17 billion. At the trial date level of over $19 billion, the effective rate of the fee under the above schedule approximated 0.288%, or $2.88

annually for each $1,000 invested. This rate is among the lowest in the industry for a Fund of this type and, at the trial date level of the Fund, the average of the size of shareholders' accounts (approximately $15,500) incurs an annual charge, for advisory and deposit and withdrawal services, of about $45.

Processing Orders for the Fund

A Fund account may be opened at the option of the customer either through MLPF&S, the Broker affiliate, or directly through The Bank of New York, the Fund's custodian and transfer agent, which is under contract as such to the Fund. A depositor in the Fund has the option of placing orders to purchase or redeem shares of the Fund through the Broker or directly through the transfer agent.

MLPF&S (the Broker affiliate) during the period under review received and processed approximately 80% of the orders for purchases of shares made by the shareholders of the Fund. When an investor purchases or redeems shares of the Fund through the Broker, such transactions are processed through a brokerage account with the Broker which is opened either specifically for purposes of deposits in the Fund, i.e., purchase of Fund shares, or through an account previously opened in connection with transactions in other securities. No charge is made to the Fund's customer for accepting the deposit, opening and maintaining of the securities brokerage account, or for the shares obtained by the deposit, or for redemptions, even if an account is opened and utilized solely for purposes of transactions in Fund

shares. Orders for the purchase or redemption of Fund shares placed through the Broker are transmitted from the branch offices by wire to computer facilities and administrative personnel in the Merrill Lynch home office.

Plaintiffs' Contentions

Plaintiffs claim that Congress intended to limit the fees of Advisers to fair charges and that the compensation to MLAM is unreasonably high and disproportionate to the services rendered and their costs.

Plaintiffs offer as an apt comparison for the compensation payable by the Fund, the compensation (unspecified) that pension fund managers are paid which plaintiffs say is only a fraction of the compensation which the Fund pays. Turning from the price paid by the Fund, plaintiffs claim that the costs of

servicing the contract by MLAM should be considered in evaluating the fairness of its compensation but should not include the expense incurred by MLAM's affiliate, MLPF&S, in the handling of the service requirements of the Fund investors and shareholders. They claim that the Broker is "unnecessarily" rendering such services and that the Transfer Agent, The Bank of New York, is allegedly capable and should perform them. They claim that the fall-out benefits to the Broker from opening accounts and servicing the money market fund needs of the investors should be considered as an offset to the expense of the Broker in processing the orders of the shareholders of the Fund. Additionally, plaintiffs attack the studies made of the costs of those services, studies made by Merrill Lynch staff as well as by independent cost accounting experts, which quantified

the processing costs; they characterize those studies as improperly performed and vastly overstating the real expense incurred. Plaintiffs add, that at all events, such expenses in reality should be considered as a cost of distribution of securities and in their view, the federal statute and regulations do not permit a mutual fund to pass along such an expense to the shareholders.

Plaintiffs also challenge the approvals of the fees to MLAM by the Trustees and the shareholders of the Fund and assert that in considering whether the compensation received was in breach of fiduciary duty, no weight should be given by the Court to their respective approvals of the advisory fee, because the Trustees allegedly failed to consider critical facts and allegedly were misled and because the shareholders were not provided with correct or adequate

information on which to make a knowledgeable ratification.

A critical examination of the actual and relevant facts concerning the issue of whether the compensation received by MLAM constituted a breach of fiduciary duty exposes the unreality and invalidity of each of plaintiffs' contentions.

The Statute

Section 36(b) of the Investment Company Act of 1940 provides that

> "the investment adviser...shall be deemed to hae a fiduciary duty with respect to the receipt of compensation for services, or of payments of a material nature, paid by such registered investment company, or by the security holders thereof, to such investment adviser or any affiliated persons of such investment adviser."

The statute expressly provides that "plaintiff shall have the burden of prov-

ing a breach of fiduciary duty."[6/]

Section 36(b) was added to the Act in 1970. Its enactment was precipated as the result of the abuses which Congress had perceived with respect to equity load funds during the 1960's. See generally S.Rep. No. 184, 91st Cong., 1st Sess., accompanying S. 2224, reprinted in [1970] U.S. Code Cong. & Ad. News 4897 [hereinafter "Senate Report"]. Money market funds were not in existence at that time. It seems clear from that fact that Congress had in mind front-end load equity funds and not today's money market funds

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6/ At common law it was incumbent on the fiduciary to justify his transaction with his cestui. Under this statute the burden is reversed. Indeed, the Report by the House Committee even considered a burden of proof "by clear and convincing evidence...in order to attempt to eliminate nuisance suits designed to harass defendants." H.R. Rep. No. 1382, 91st Cong., 2d Sess. 38 (1970) [hereinafter "House Report"].

which are no-load and in which a shareholder can redeem his shares without the payment of any penalty or tax consequences, and freely invest his funds without expense, on virtually the same terms, in any one of the large number of other funds available in the market place.

The basic contention of plaintiffs in these cases is that MLAM is making "too much" money and that this, in and of itself, constitutes a violation of the fiduciary duty imposed upon investment advisers by Section 36(b). However, Congress explicitly, recognized "the fact that the investment adviser is entitled to make a profit. Nothing in the bill is intended to imply otherwise..." Senate Report at 6. The price charged for the service is the key fact -- the cost to the fiduciary of rendering the service is of relative unimportance.

Congress has made it very clear in the legislative history that it rejected any concept that Section 36(b) should impose a "cost plus" basis as a standard or that the Court should engage in rate-making.[7/]

The Senate Report cited above accompanying the 1970 amendments makes it evident that Congress did not intend the Courts to "second-guess" the business judgment of the independent trustees with respect to the size of the investment advisory fee:

> Nothing in the bill is intended to ...suggest that a "cost-plus" type of contract would be required. It is not intended to introduce general concepts of rate regulation as applied to public utilities.

7/ Congress has twice declined to pass legislation which would have imposed a "reasonableness" standard. Bills introduced in the House and Senate in 1967 and 1968 would have required advisory fees to be "reasonable", but were never enacted. See S. 3724, 90th Cong., 2d Sess. (1968).

* * *

> This section is <u>not intended to authorize a Court to substitute its business judgment for that of the mutual fund's board of directors</u> in the area of management fees.
>
> * * *
>
> Th[is] section is not intended to shift the responsibility for managing an investment company in the best interest of its shareholders from the directors of such company to the judiciary. <u>Senate Report</u> at 6-7. (Emphasis supplied).

As one commentator pointed out, Congress moved away from testing the amount of the compensation and focused instead on the adviser's conduct:

> The deletion of the reasonableness standard and substitution of the adviser's fiduciary obligation changed not only the standard of judicial review but the method for testing management's compensation. The test no longer modified the fee in Sec. 15 but was made part of the adviser's duties under Sec. 36.

Nutt, <u>A Study of Mutual Fund Independent Directors</u>, 120 U. Pa. L. Rev. 179, 190 n. 61 (1971).

The Second Circuit, in its opinion affirming this Court's decision to strike plaintiff's jury demand, specifically adopted the Pennsylvania Law Review analysis:

> The original bills introduced in the Senate and the House provided that the propriety of charges should be determined by the test of "reasonableness". (Citations omitted). Influenced in part by industry opposition to the "reasonableness" standard, Congress shifted, to the standard of "fiduciary duty" that is in the present act.

In re Gartenberg, 636 F.2d 16, 17 (2d Cir. 1980), cert. denied, 101 S. Ct. 1979 (1981).

The Congress was not precise in delineating the test for compliance with the fiduciary standard by which to judge the acceptability of compensation to a money market fund advisor. The fiduciary standard "imposes a high degree of legal commitment to treat the fund with utmost fairness." 116 Cong. Rec. 33282 (1970)

(remarks of Rep. Springer.) Some members of Congress left open the possibility that in certain limited circumstances, the fee, considered by itself, might be enough to prove a breach of the Section 36(b) standard. Senator Bennett, in his remarks on the bill, stated that the section authorized lawsuits "in the event that the fee received is claimed to be so excessive as to constitute a breach of fiduciary duty." 115 Cong. Rec. 13693 (1969) (emphasis added.) In the House, Representative Moss stated that the duty was "a legal obligation to so administer and so charge the fund so that [the adviser] does not commit an excess against the fund." 116 Cong. Rec. 33281 (emphasis added).

While Congress rejected any attempt to rest the inquiry on what was "reasonable", it did not indicate that the

common law standard of "corporate waste", which had previously been available to challenge advisory fees, was to be disregarded as an element of the Court's inquiry.[8/] The Senate committee explicitly "decided [only] that the standard of 'corporate waste' [was] unduly restrictive." Senate Report, at 5. Section 36(b) was an attempt to strengthen, not erode, that standard. See Tannenbaum v. Zeller, 552 F.2d 402, 416 n. 20 (2d Cir. 1977), cert. denied 431 U.S. 934 (1977); Herzog v. Russell, 483 F. Supp. 1346, 1349 n. 1 (E.D.N.Y. 1979).

Specific purposes to be served under Section 36(b) were stated in the legislative history and these may be summarized

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8/ See, e.g., Saxe v. Brady, 40 Del. Ch. 474, 184 A.2d 602 (1962); Meiselman v. Eberstadt, 39 Del. Ch. 563, 170 A.2d 720 (1961); Acampora v. Burkland, 220 F. Supp. 527 (D. Colo. 1963).

as follows. These purposes serve as the only congressional guide to the principles of the judicial review of compensation obtained by a fiduciary of a money market fund.

The Intention of the Legislation

1. What is intended:

(a) That the investment adviser is entitled to make a profit.

2. What is not intended:

(a) That a cost-plus type of contract is required.

(b) That general concepts of rate regulation as applies to public utilities are to be introduced.

(c) That the standard of "corporate waste" is to be applied.

(d) That management fees should be tested on whether they are "reasonable."

(e) That a congressional finding has been made that the present industry level or that the fee of any particular adviser is too high.

(f) That the Court is authorized to substitute its business judgment for that of the directors.

(g) That the responsibility for management is to be shifted from directors to the judiciary.

(h) That economies of scale are necessarily applicable at every stage of growth of the Fund.

3. The test of fairness is <u>to be made</u> by the Court, in part:

(a) By reference to industry practice.

(b) By reference to industry level of management fees.

4. The Court shall determine <u>whether</u>

(c) The attention of directors was fixed on their responsibilities.

(d) The directors requested and obtained information reasonably necessary to evaluate the terms of the management contract.

(e) The directors having the primary responsibility for looking after the best interests of the Fund's shareholders, have evaluated such information accordingly.

The net intent of the legislation to the extent it was expressed would seem to leave it to the federal courts to interpret compliance with "fiduciary duty" in the common law tradition (in

this case "federal common law", really federal equity jurisprudence). Thus viewed, Section 36(b) represents a political compromise of a highly emotional nature which eschews rate regulation for personal services but nonetheless caps compensation at market acceptability accompanied by good faith and fair disclosure of that range.

An examination of the case authorities also fails to illumine precisely the path to be followed by the Court in weighing the compensation of the investment adviser of a money market fund under fiduciary standards. Only general concepts have been articulated. The standard of fiduciary duty under Section 36(b) "is concerned solely with fairness and equity." In re Gartenberg, 636 F.2d 16, 17 (2d Cir. 1980), cert. denied, 101 S. Ct. 1979 (1981). "The essence of the [fiduciary] test is whether or not under

all the circumstances the transaction carries the earmarks of an arm's length bargain." Pepper v. Litton, 308 U.S. 295, 306-07, (1939).

The conduct of the investment adviser must be governed by the "duty of uncompromising fidelity" and "undivided loyalty" to the Fund's shareholders that is imposed by Section 36(b). Galfand v. Chestnutt, 545 F.2d 807, 809, 811 (2d Cir. 1976). For example, the investment adviser because he is a fiduciary, may not sell his office for personal gain. Rosenfeld v. Black, 445 F.2d 1337, 1342 (2d Cir. 1971), cert. dismissed 409 U.S. 802 (1972). When "endeavoring to influence the selection of a successor," a fiduciary must act "with an eye single to the best interests of the beneficiaries." Id. Moreover, it is well settled that the investment adviser owes a duty of

full disclosure to the trustees and shareholders of the Fund. Galfand, 545 F.2d at 811. See Tannenbaum v. Zeller, 552 F.2d 402, 417 (2d Cir.), cert. denied, 431 U.S. 934 (1977) (Sec. 36(a)); Fogel v. Chestnutt, 533 F.2d 731, 750 (2d Cir. 1975), cert. denied, 429 U.S. 824 (1976); Moses v. Burgin, 445 F.2d 369 (1st Cir. 1971), cert. denied, 404 U.S. 994 (1971). And even when full disclosure has been made, the courts must "subject the transaction to rigorous scrutiny for fairness." Galfand, 545 F.2d at 811-12; Krasner v. Dreyfus Corp., 90 F.R.D. 665 (S.D.N.Y. 1981).

The Fairness of the Advisory Fee

In determining whether MLAM has breached its fiduciary duty, this Court must primarily examine what the Fund paid and what it received. The Court must consider the "nature, quality and

extent" of the services to the Fund in relation to the fee paid by the Fund. Note, Mutual Fund Advisory Fees -- Too Much for Too Little? 48 Fordham L. Rev. 530, 545 (1980). Accord, Krasner v. Dreyfus Corp. 500 F.Supp. 36 (S.D.N.Y. 1980). Congress intended

> that the court look to all facts in connection with the determination and receipt of such compensation, including all services rendered to the fund or its shareholders and all compensation and payments received, in order to reach a decision as to whether the adviser has properly acted as a fiduciary in relation to such compensation. Senate Report, at 15; House Report, at 37.

The legislation permits the Court to give such weight as it may allow to the approval of the investment advisory agreement by the trustees and shareholders of the Fund.

It bears repeating that in order to provide relief under Section 36(b), it is not enough for this Court to find

that a better bargain was possible. Instead, plaintiffs can prevail only of this Court finds that MLAM received compensation under an agreement that was unfair to the Fund and its shareholders.

A. The Nature, Quality and Extent of the Services Provided in Relation to the Fee Paid.

1. The services provided

Merrill Lynch provides three types of services to the Fund. MLAM manages the Fund's portfolio and has important administrative functions, while MLPF&S, under a contractual arrangement with MLFD, provides the overwhelming bulk of shareholder services.

Plaintiffs contend that MLAM's performance in managing the Fund's portfolio has been "only fair." Defendants counter that the Fund's performance has been "substantially above average."

Accordinging to Donoghue's Money Fund Report, whether all money market funds

are considered, or only stockbroker-sponsored funds, the Fund's yield has been above average for 1978, 1979, and 1980.[9/] For 1980, in terms of its yield, the Fund ranked 37th out of all 76 money funds and 10th out of the 22 stockbroker-sponsored money funds.

These figures are not entirely inconclusive. While the Fund's performance, as measured by its yield, has not been spectacular, neither has it been disappointing. The Fund's performance assures its customers that they may safely take advantage of the high interest rates af-

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Type of Fund	Average Yield (%)		
	1978	1979	1980
The Fund	7.24	10.61	12.09
All Stockbroker-sponsored	7.08	10.59	12.03
All Funds	7.00	10.55	11.94

Figures for the current calendar year are not supplied in the record.

forded by money market instruments without fear that their return will be below the industry average.

Pursuant to the investment advisory agreement, MLAM furnishes to the Fund "office space and all necessary office facilities for managing the affairs and investments and keeping the books of the [Fund]." MLAM is responsible for the Fund's compliance with all the applicable record-keeping and reporting requirements of federal securities and state Blue Sky laws. Moreover, MLAM coordinates the operation of the various entities that perform services for the Fund, such as the accountant, Transfer Agent and Broker. Neither plaintiff has denied that MLAM has been fully competent in performing these general administrative services, despite the unprecedented size of the Fund.

It is the shareholder services provided to Fund shareholders by MLPF&S that distinguish it from its competitors in the money market industry. Under section 7 of the distribution agreement, MLFD entered into a selected dealer agreement with MLPF&S. As a result, the vast facilities of the Broker are available to transmit and process Fund orders.

In particular, any one of the MLPF&S account executives can enter a shareholder's order to purchase or redeem Fund shares, and can provide information concerning the Fund's current yield and the status of the shareholder's account over the telephone. Moreover, the account executive can arrange to invest funds in the Fund or redeem shares overnight, and can place idle money in the Fund for as little as one day.

MLPF&S has continued to provide these services and the number of Fund orders processed through the Broker has almost doubled from 1979 to 1980. Indeed, during the first six months of 1981 the rate at which orders were processed was nearly 3 3/4 times the 1979 rate.10/

2. The fee paid

In return for these services, the Fund pays MLAM a fee according to a schedule that is the subject of the present suit. In evaluating this fee, it must be recognized that the Fund is

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10/ In 1979, 2,486,792 Fund orders were processed through the Broker. In 1980, the number of orders almost doubled, to 4,949,200. In the first six months of 1981, 4,646,800 orders were processed.

The difficulty of planning for such increases is exacerbated by the fact that the rate of increase is unstable. In eight of the twelve months of 1980, for example, the rate of change in Fund orders changed by nearly ten percentage points or more.

by far the largest money market fund in existence, and has been so doing the period with which this suit is concerned.[11/] In such a situation, industry comparisons can never be entirely persuasive. Even with this caveat in mind, MLAM's fee compared very favorably with others in the industry. First of all, the Fund pays one of the lowest effective rates of any money market fund. At current asset levels, the effective fee is less than 0.29%, or less than $2.90 for every $1,000 invested in the Fund.[12/] Moreover, the Fund's

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11 At the time of trial, the Fund had triple the net assets of the next largest fund not sponsored by Merrill Lynch.

12 The record shows that as of March 4, 1981, only the Temporary Investment Fund, which had an effective rate of 0.231%, was charging at a lower rate than the Fund. The Union Cash Management Fund, with an effective rate of 0.20%, is internally managed, and therefore cannot be properly compared.

ratio of expenses to average net assets is in line. At least 16 funds of all types had higher expense ratios, while five had lower ratios.

3. <u>The net earnings as a result of providing the services</u>

The price that the market will pay for the services involved is a principal consideration in evaluating its fairness. Costs of the services enter into the determination of the price to be demanded by the Adviser, but price to the Fund is critical, not cost to the supplier. The competitive price in the market is what sells the services; cost to the Adviser is not the way the service is sold.

Plaintiffs contend that direct costs to MLAM, including personnel costs, bookkeeping and office supplies, only, may properly be considered in determining whether the fee is fair. They contend, moreover, that the costs incurred by

MLPF&S associated with the opening of a Fund account and in providing the shareholder services that are one of the most distinguishing features of the Fund, may not properly be considered, because MLPF&S is not obligated to perform them.

Nothing in Section 36(b) obligates this Court, in assessing the fairness of the investment advisory compensation, to restrict its vision only to those services performed directly by MLAM. Indeed, the statute recognizes that in order to promptly assess the fairness of advisory compensation, the courts cannot be strictly bound by corporate structure and ignore closely related entities whose functions intimately impinge on one another. The statute itself speaks of payment for the services of the advisor "or any affiliated persons of such investment adviser." 15 U.S.C.

Sec. 80a-35(b) (1976). As both the Senate and the House reports stated:

> [I]t is intended that the court look at all the facts in connection with the determination and receipt of such compensation, <u>including all services rendered to the fund or its shareholders</u> and all compensation and payments received, in order to reach a decision as to whether the adviser has properly acted as fiduciary in relation to such compensation. <u>Senate Report</u> at 15; <u>House Report</u>, at 37.

That the courts are not required blindly to adhere to corporate organization when there is no reason to do so also follows from the equitable nature of their task under Section 36(b). Equity has traditionally refused to be hemmed in by rigid boundaries; on the contrary, equitable powers are inherently flexible. "Equity always attempts to get at the substance of things, and to ascertain, uphold, and enforce rights and duties which spring from the <u>real</u> relations of parties." 1 J. Pomeroy, <u>A</u>

Treatise on Equity Jurisprudence Sec. 378 (4th ed. 1918).

In this case, both MLAM and MLPF&S are wholly-owned by Merrill Lynch & Co., Inc. MLPF&S has a selected dealer agreement with the Fund's Distributor which authorizes it to process Fund orders. Most importantly, MLPF&S provides Fund customers with convenient access to the Fund through the enormous Merrill Lynch brokerage system. It is undoubtedly as a result of the convenience to them that the customers select MLPF&S to process the overwhelming majority of Fund orders 13/ and the Fund has

13/ Since June 1978, the number of orders for purchases and redemptions of Fund shares processed through the Broker and the Transfer Agent has been as follows:

become the largest of its kind in the world. And yet, since the investors are not charged a sales load for processing Fund orders, MLPF&S is not compensated directly for providing these shareholder services. There are significant advantages to purchasing and redeeming shares

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(Footnote 13/ continued:)

Orders Processed for the Fund

Date	By MLFP&S	By Transfer Agent
7/78 - 12/78	437,282	(not available)
1979	2,486,792	(not available)
1980	4,949,200 (79.8%)	1,253,773 (20.2%)
1/81 - 6/81	4,646,880 (83.4%)	924,057 (16.6%)

A comparison of the number of new Fund accounts opened in 1980 and 1981 processed through the Broker and through the Transfer Agent is as follows:

New Accounts Opened Through:	Broker	Transfer Agent
1980	541,682 (99.05%)	5,158 (0.95%)
1/81 - 6/81	503,962 (97.4%)	12,996 (2.51%)

of the Fund through a securities brokerage account maintained with MLPF&S which are not available to individuals who process their transactions through the Transfer Agent. The flexibility available to an investor to swing from one form of investment to another, simply, efficiently and without cost is of considerable advantage to the Fund shareholder.

In sum, it appears that MLPF&S provides an essential portion of the total package of services that may properly be compensated by the advisory fee. Certainly Merrill Lynch's own internal actions demonstrate that it believed this to be the case, since for the past two years it has required MLAM to reimburse MLPF&S for estimates of its costs in processing Fund orders, based on the lowest internal estimates thereof.

In view of these considerations, the processing costs to MLPF&S may properly

be considered in assessing the fairness of the compensation paid by the Fund.

4. Costs of providing the processing services

The record shows that the costs to MLPF&S of providing processing services to the fund, though uncertain in amount, were substantial. There have been three basic estimates of the costs to MLPF&S of processing Fund orders, ranging from $2 to $7.50 per transaction. These studies were undertaken as a result of the exploding volume of orders that the Fund was experiencing.

The earliest estimate was calculated by Robert Diemer, an official with Merrill Lynch's Diversified Financial Services Group, which oversees Merrill Lynch's money funds. Using figures for the first quarter of 1979, Diemer combined the direct processing costs to MLPF&S (essentially the costs of entering

and executing a Fund order) with an allocation for the costs of Merrill Lynch's branch offices, and concluded that it cost MLPF&S $5.06 for every Fund order it processed.[14/]

Even though Diemer had stated earlier that any allocation of branch expenses "would be subjective at best," he concluded that an allocation of branch expenses based on MLAM revenue as a percentage of total Merrill Lynch "production credits" would be most appropriate.[15/] Since MLAM revenue

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14/ A "Fund order" is a transaction with the Fund, and includes both purchases and redemptions of Fund shares as well as the incidents in the servicing of accounts.

15/ Production credits, are based largely on, but are not congruent with commission revenue. Merrill Lynch's internal cost accounting system allocated costs according to production credits. Since MLPF&S did not charge the customer a sales load to process Fund orders, its activities with regard to the Fund did not generate any production credits and

constituted 1.3% of all production credits, Diemer allocated 1.3% of MLPF&S branch expenses to the processing of Fund orders.

Diemer's estimate was met with firm opposition from Arthur Zeikel, the president of MLAM, who thought it overstated the Fund's burden on MLPF&S. Diemer had allocated a portion of total branch expenses to arrive at his estimate, but Zeikel thought an incremental cost approach would be more accurate, since most of MLPF&S branch costs would still remain even if the Fund were not in existence. On August 24, 1979, a memo was prepared by F.G. Fitz-Gerald, vice-president and chief financial officer of Merrill Lynch & Co., Inc., which showed the incremental

(Footnote 15/ continued):

its costs were not allocated automatically by MLAM's accounting system. MLAM revenue was therefore used as a substitute to allocate costs appropriately within the system.

costs of the Fund to MLPF&S for the first quarter of 1979 to be $2.02 per order.16/ On the basis of his figures, Fitz-Gerald recommended that MLAM reimburse MLPF&S for allocated processing costs according to the following schedule:

First 500,000 orders	$3.00 per order
Second 500,000 orders	$2.00 per order
Balance	$1.50 per order

The most recent estimate of MLPF&S's processing costs was made by the independent accounting firm of Peat, Marwick, Mitchell & Co. ("PMM") in anticipation of this litigation. The results of the study were reported to the Fund's Trustees on April 24, 1980 in connection with their annual consideration of the fee schedule of the Fund. Rather than

16/ For 1978, Fitz-Gerald found the incremental cost to be $2.16 per order. Fitz-Gerald also estimated the standard cost of processing a Fund order to be $3.30 for the same period.

constructing an entire new system of cost analysis of their own, PMM conducted an independent evaluation of how the costs should be allocated. PMM accountants visited a representative sample of Merrill Lynch branches all over the country and studied how much of their time was spent on Fund business.17/ PMM dealt most extensively with figures for the third quarter of 1979, and updated its findings quaterly until the first quarter of 1981. For the third quarter of 1979, PMM found that it cost MLPF&S $9.74 per order to process Fund orders. For the fourth quarter of 1979, its study showed that processing costs were $7.47 per order. Since then, in

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17/ Since PMM allocated a portion of total branch costs, it, like Diemer, used a full cost rather than an incremental cost approach.

PMM's view, processing costs have remained in the range of $7.00 per order.18/

The PMM study was by far the most comprehensive of the three, and the only one that involved any independent investigation of the costs at all. The partner in charge, Russell Peppet, presently vice-chairman of PMM and a cost accountant for over twenty years, testified that over 1,500 man-hours were spent on the study.

It would be an exceedingly difficult task for this Court to choose the proper method of accounting for determining the costs to MLPF&S of processing Fund orders

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18/ PMM's figures are arguably conservative, since they do not allocate to the Fund any of the compensation of account executives, even though PMM found on the average that 10.25% of the typical account executive's time was devoted to Fund matters.

The problem with using full cost accounting in allocating MLPF&S branch expenses to the Fund is that branch personnel and facilities were largely in place before the Fund existed and will be needed to nearly the same extent if the Fund were discontinued. Yet the extraordinary success of the Fund has meant that an incremental cost accounting approach is probably inappropriate as well. At the end of April, 1981, Fund orders constituted 37% of all business processed by MLPF&S. To handle the additional volume generated by the shareholders and customers of the Fund, Merrill Lynch had to hire approximately 3,000 non-sales personnel. By the time the Trustees met on May 7, 1981, these considerations had convinced even Arthur Zeikel, who had originally pressed for such an approach, that the costs of processing Fund orders were too great to be analyzed on a

strictly incremental basis.

The compensation accepted by the Adviser was not unfair whether viewed with or without consideration of the processing costs. The fees that are in dispute in this case derive from the schedule approved by the Trustees on April 24, 1980 and May 7, 1981. It cannot be gainsaid herein that the rate of fees are thoroughly in line with the market; the trial exhibits are conclusive on this score. In the month of April, 1980, the compensation actually paid to MLAM was approximately $2,479,565, which amounted to an annualized rate of $29,754,780. In April, 1981, just before the latest renewal of the fee schedule, the payments were running at a rate of $3,998,961 per month, or $47,987,532 per year.

On the other hand, it appears to the Court to be entirely proper for the fiduciary to consider the totality of the values placed at the disposal of the shareholders in appraising the fairness of the compensation, or else form would be substituted for substance. Considering its current size, the Fund could not be administered without the branch office and wire system provided by MLPF&S to handle the enormous volume of orders from shareholders for the purchase and redemption of shares and the informational services supplied. Moreover, it is self-evident that the larger the size of the Fund, the greater the investment advantages to the shareholders, advantages not available to smaller funds.

5. The "distribution expense" argument

Plaintiffs argue that these cost estimates for servicing the interests

of the Fund and its shareholders do not measure expenses properly compensable by the Fund because they constitute "distribution" expenses under Section 12(b) of the Investment Company Act of 1940, which provides that:

> It shall be unlawful for any registered open-end company (other than a company complying with the provisions of section 80a-10(d) of this title) to act as a distributor of securities of which it is the issuer, except through an underwriter, in contravention of such rules and regulations as the [SEC] may prescribe as necessary or appropriate in the public interest or for the protection of investors. 15 U.S.C. Sec. 80a-12(b) (1976).

However, plaintiffs have failed to prove that any of MLPF&S's processing costs are of the character of forbidden "distribution" expenses. The costs associated with the booking of orders and administrative costs associated with share orders and maintaining the accounts of investors in the Fund are managerial

functions rather than promotional expenses.

Under Rule 12b-1, an investment company "will be deemed to be acting as a distributor of securities of which it is the issuer, other than through an underwriter, if it engages directly or indirectly in financing any activity which is primarily intended to result in the sale of shares issued by such company." 17 C.F.R. Sec 270.12b-1(2) (1981). The activity here of MLPF&S was not "primarily intended to result in the sale of shares."

In support of their argument seeking to ascribe distribution to the processing function, plaintiffs point to the fact that Merrill Lynch's internal documents referred to the branch expenses portion of MLPF&S processing costs as "branch office selling expenses." By attempting to equate Merrill Lynch's use of the

word "selling" with forbidden "distribution" under the SEC rule, plaintiffs had hoped-but failed-to show that some portion of the processing costs were in reality distribution costs which cannot be considered in assessing the reasonableness of the advisory fee.

Plaintiffs have failed to demonstrate that the branch office selling expenses were in fact related to activity intended to result in the sale of Fund shares. Branch expenses were allocated in order to derive a figure for how much it cost MLPF&S to process Fund orders; the allocated expenses did not pretend to describe what activities branch personnel actually performed in processing Fund oprders. Even PMM, which did the most detailed survey of branch activity, only calculated how much time branch personnel, devoted to Fund processing and not

whether they devoted that time to selling or not.

What evidence there is goes against plaintiffs' contention that a significant portion of MLPF&S' processing costs are distribution expenses. Much of MLPF&S' processing costs have to do with the redemption of Fund shares and the administrative functions involved in servicing existing shareholder accounts. Such costs do not relate to the sale of Fund shares at all. It it apparent, moreover, that all throughout the period under consideration the compelling impetus has been to seek high interest returns on money deposits. In essence, therefore, Fund shares have been bought, not sold; there was no basis in the evidence of activity primarily intended to result in the sale of Fund shares.

If there is indeed any relevance to costs as contrasted with the price of

services as established in the market, then processing costs are properly to be taken account of in measuring performance of fiduciary obligation. Moreover, this Court does not have to choose the most accurate cost accounting method to measure the processing costs attributable to the requirements of investors and the Fund, for whichever estimate of cost to MLPF&S of processing Fund orders is used, the net compensation to the Merrill Lynch organization as a whole does not appear unfair.19/ Indeed, as the following chart shows, utilizing the Diemer and the PMM cost estimates in the calculation of MLAM's after-tax income

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19/ Even plaintiffs' witness, an economist, said that if he were to assume that processing costs are properly taken into account in determining the compensation paid to the fiduciary he would not be able to formulate an opinion as to the reasonableness of the Investment Advisor's compensation.

suggests that the Fund may currently even be a net losing proposition to the Merrill Lynch organization.[20/] Even using Fitz-Gerald's lower estimate for processing costs, it appears that the Merrill Lynch organization received less than $6.2 million in after-tax income in compensation for servicing the billions of dollars managed for the Fund and its shareholders in the twelve month period ending June 30, 1981 and a little over $5 million in the calendar year 1980.

It is obviously appropriate to view the net results to the fiduciary of the compensation he receives, after taxes, in considering the question of the fairness with which a fiduciary serves a

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20/ Others have recognized that money market funds might in fact lose money for their sponsors. See 601 Sec. Reg. & L. Rep. (BNA) A-4, 5 (Apr. 29, 1981) (remarks of Adrian L. Banky, senior vice-president of the Securities Industries Ass'n.).

fund. See Black v. Parker Mfg. Co., 329 Mass. 105, 117, 106 N.E.2d 544, 552 (1952) ("The effect of taxes on the income of the individual, as well as on the income of the corporation, is properly to be considered in determining the reasonableness of the salaries paid."). To the same effect, see Heller v. Boylan, 29 N.Y.S.2d 653, 674 (N.Y. Sup.Ct. 1941), aff'd, 263 App. Div. 815, 32 N.Y.S.2d 131 (1st Dep't 1941) ("A consideration of these enormous payments cannot ignore the high toll of the tax collector").

ML ASSET MANAGEMENT, INC.

ML Ready Assets Trust	Calendar Year 1980	6/30/80-6/30/81
Average Net Assets	$11.16 Billion	$13.52 Billion
Average No. of Share-holders	675,324	835,618

ML Ready Assets Trust	Calendar Year 1980	6/30/80-6/30/81
Management Fee --MLAM	$33,008,025	$39,369,587
MLAM Direct Expenses		
Office & Salary	1,567,847	1,567,847*
Income Tax (55.774%)	17,535,445	21,083,543
Net Earnings	13,904,733	16,718,197
Order Volume Through MLPF&S	4,949,200	6,096,537
Processing Costs		
Reimbursement to MLPF&S	8,563,000**	N/A
ML (Fitzgerald) - estimated	8,813,800	10,534,805

* The figure for office and salary expenses in calendar year 1980 was used as an estimate for such expenses for the period 6/30/80 - 6/30/81.

** Reimbursement was based on the Fitz-Gerald schedule, but differs slightly from it because different (evidently tentative) figures for order volume were used.

ML (Diemer) - estimated	25,042,952	30,848,477
PMM & Co. - estimated	36,970,524	45,541,131
Profitability of Services Supplied		
After reimbursement to MLPF&S	5,341,733	N/A
After ML (Fitz-Gerald) - estimate	5,090,933	6,183,392
After ML (Diemer) estimate	(11,138,219)***	(14,130.280)***
After PMM & Co. estimate	(23,065,791)***	(28,822,934)***

Even adopting the lowest estimate of the processing costs (the reimbursement figure of the Fitz-Gerald estimate), the profitability of administering the Fund and the shareholder services amounted to four and a half ten thousandths (0.00045) of the average net assets under supervision.

*** Subject to adjustment of the income tax liability shown above.

Plaintiffs also argue that the processing services of MLPF&S involved in the foregoing estimates of cost overlap aspects of MLPFD's obligations under its Distribution Agreement with the Fund. The attempt to illustrate this on cross-examination failed and the exhibits do not support that claim beyond the possibility of some minor portion of the services rendered by MLPF&S. The bulk of the processing services are not the same services that MLFD is bound by contract to perform; the processing costs, while difficult to ascertain with any precision, are clearly of great magnitude for which no adequate substitute is readily available.

B. Economies of Scale

As one factor in assessing the fairness of the advisory agreement, Congress intended that the courts determine whether the investment advisor has taken

account of any economies of scale in the management of the fund in setting the advisory fee. "[T]his bill recognizes that investors should share equitably, as they do in other areas, in the economies available as a result of the growth and general acceptance of mutual funds." Senate Report at 4. As Senator Percy stated:

> Adequate compensation and incentives must be provided to companies and individuals which advise the fund on its investments and market fund shares; however, individual investors must share equitably in the economies of scale available as a result of tremendous growth in this industry. 115 Cong. Rec. 13699-700 (1969).

Congress implicitly recognized that it might be impossible in some instances to conform to the "desirable tendency on the part of some fund managers to reduce their effective charges as the fund grows in size. Accordingly, the best industry practice will provide a guide." Senate Report, at 6.

Clearly, the present schedule takes account of economies of scale; the rate of fees diminishes progressively. See Kreasner v. Dreyfus Corp., 90 F.R.D. 665, 669 (S.D.N.Y. 1981).

Defendants have raised doubts as to whether there are further economies of scale in the provision of the services. While the unit costs of portfolio management and general administrative services have almost certainly declined as the Fund has grown, the far greater costs of providing shareholder services appear to have remained relatively stable.

As the trustees were informed in 1980, this was MLAM's reason for refusing to introduce any additional breakpoints.

> MLAM does not propose to introduce additional breakpoints at assets levels of $2.5 billion because it believes the economies of scale applicable at lower asset levels tend to diminish when the fee rate reaches 0.275%...,.[T]his "diminishing

> return" occurs largely because the costs of MLAM and Merrill Lynch associated with processing orders and administering shareholder accounts have not diminished as assets increase beyond the $2.5 billion level.

Of the three studies of processing costs available to the Court, the only one which was performed over a significant number of quarterly periods was the PMM study. That study found that unit processing costs did not significantly diminish as the Fund grew larger. In the fourth quarter of 1979, for example, costs per order amounted to $7.63, while by the first quarter of 1981 they were only $.35 less. Of course, if the number of shareholder orders increased at a slower rate than the asset level, Merrill Lynch would still be making more money even though the cost of processing a single order remained the same. However, it appears that the ratio of order volume to assets did not diminish

as the Fund grew larger. From June 1980 to June 1981 the ratio of order volume to Fund assets actually increased, from .0000287 to .0000392.

That processing costs do not significantly diminish as Fund assets increase accords with logic and common sense. While it may be almost as easy to invest a block of $100 million as a block of $10 million, it requires substantially more time, money and personnel to process 1 million shareholder orders than 100,000 orders. The ease and speed with which Fund shares can be bought or redeemed is crucial to the success of any money market fund, especially since the investor loses money for every minute his funds lie unemployed. Merrill Lynch added more than 3,000 non-sales peronnel to handle the additional transaction volume caused by the Fund.

In any event, even if there do exist economies of scale, the present structure of MLAM's fee means that its effective fee has decreased as the size of the Fund has grown.

In view of the above considerations, the total compensation paid for the services supplied adequately passes a "rigorous scrutiny for fairness." see Galfand v. Chestnutt, 545 F.2d 807, 811-12 (2d Cir. 1976). The ultimate decision of the Trustees was objectively reasonable, as the total fee was fair to the Fund.

C. The Benefits to Merrill Lynch As a Whole Because of the Fund

Plaintiffs also contend that MLAM distorted the burden shouldered by MLPF&S by describing only the costs associated with Fund transactions without offsetting therefrom the value of associated fall-out business allegedly realized by MLPF&S.

Plaintiffs argue that the Fund is an important sales tool for the Merrill Lynch organization as a whole, for it allows Merrill Lynch to attract new accounts and retain existing ones. They argue that having opened up an account with Merrill Lynch in order to gain access to the Fund, customers will find it convenient to transact other sorts of financial buisness with Merrill Lynch. Moreover, using the Fund, Merrill Lynch presumably can retain control over its customers' money, since account executives can urge that customers deposit their money in the Fund between commission-generating securities trades. Lastly, plaintiffs say that Fund customers are more likely to choose Merrill Lynch as their broker in the event of an upturn in the stock market.

The principal difficulty with plaintiffs' contentions lies in measuring the

value of these beneficial aspects of the relationship. Plaintiffs' witness, Donald Peskin, an employee of the accounting firm of Laventhol & Horwath, testified that it would be possible to measure how much business came into Merrill Lynch from customers who were originally attracted by the Fund. For example, the study performed by PMM showed that 38% of those customers who opened an account with Merrill Lynch by buying shares of the Fund in the third quarter of 1979 did some non-Fund business by January 1980. Peskin thought it would be possible, as a statistical matter, to estimate how much non-Fund revenue such customers generated. However, as he conceded, some new customers who opened a Fund account and then did other business with Merrill Lynch might have done so even had the Fund not existed. Defendants' expert,

Russell Peppet, thought this problem of circularity would make any calculation of fall-out benefits "extremely difficult."

Similarly, even assuming that customers with Fund accounts did more than the average amount of brokerage business,21/ it would be difficult to demonstrate whether the increase in brokerage activity was a result of the Fund's existence, or whether customers who normally did an above-average level of brokerage business also tended to have Fund accounts.

The difficulty in proving cause and effect is also present in measuring the value of having a large pool of customers' assets close at hand in the event of development of an interest to invest in the stock market. While Peskin suggested

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21/ Other than speculation by the plaintiffs, there is no basis for such an assumption in the record.

that it would be possible to estimate the increase in brokerage business corresponding to a drop in the Fund's asset level, he did not state how he could tell what portion of the funds would not have gone to Merrill Lynch in any event. After all, any developing interest in the stock market is bound to result in an increase in Merrill Lynch's brokerage business from Fund customers. Even if it could be proved that persons with Fund accounts increased their brokerage business by a greater than average amount when the stock market improved, this would not demonstrate that the Fund's existence was the cause. As with the issue of non-Fund brokerage business in general, the possibility exists that those customers that react most strongly to an incentive to participate in the securities market are also those most likely to have an

account with the Fund at the present time, and not vice-versa.[22/]

The testimony of both Peskin and Peppet demonstrates that any study of the benefits to Merrill Lynch as a result of the Fund's existence would be difficult, time-consuming and expense, and probably entirely inconclusive, even if all of the logical problems could be resolved. Indeed, plaintiffs concede that they could not afford to hire Laventhol to perform any of the studies that they speculated were possible. Thus, the Court cannot be assured that all, or indeed any, of the studies suggested (but not performed) by the plaintiffs were in fact practical or would be illuminating.

22/ Since no one pretends to know when activity in the market will occur, it would be difficult to measure the present value of a future increase in brokerage business.

As the Audit Committee minutes for its annual meetings in 1980 and 1981 show, the independent trustees were aware that there were "potential benefits to Merrill Lynch of the interface with the Trust...including new account opportunities and continued influence over the investment of Merrill Lynch customer assets." It is true that they were not provided with dollar estimates of those benefits, but plaintiffs have not demonstrated that meaningful estimates could be provided even with extreme difficulty and expense. In these circumstances, MLAM discharged its fiduciary duty by making sure (which it did) that the Trustees were informed of the types of conceivable benefits the Fund's existence might confer on the Merrill Lynch organization.

Taken from another view, the hypothesized but not proved fall-out benefits

proclaimed by the plaintiffs to have been obtained by Merrill Lynch through the servicing of Fund shareholder requirements furnish no offset to the cost of compensability of that processing. There is no logical reason why a mutual fund shareholder should not pay for processing the Fund orders executed for him because he also pays a commission to the brokerage firm on the purchase of stocks and bonds; one does not offset the other.

Plaintiffs also argued that Merrill Lynch derives income from the "float" on checks to redeeming customers from reciprocal business from those institutions which the Fund invests, and from transactions with the Fund as principal through Merrill Lynch Government Securities, Inc.

The overwhelming majority of customers redeem Fund shares through the broker

rather than the Transfer Agent, the Bank of New York. When a redemption occurs, money is transferred from the Fund to MLPF&S. From the time the checks are issued by the MLPF&S until the time they are finally presented to its bank for payment, MLPF&S has the use of the funds which it can invest as it wishes. Plaintiffs complain that the Trustees were never told of this benefit to Merrill Lynch. However, the Trustees were aware of the way in which orders were processed through MLPF&S.[23/] and consequently, it was obvious that there was a possibility of a float. Thus there was no breach by MLAM of its fiduciary duty in failing to actually calculate the value of having the use of

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23/. For example, on May 8, 1979, the Trustees received an overview of the way in which purchases and redemptions were processed through MLPF&S.

the money while checks to Fund customers were still outstanding.

The absurdity of the claim that the Bank of New York was in a position to perform the services MLPF&S provided to the Fund shareholders needs little attention. Suffice it to say that there was no proof adduced by plaintiffs that there was unnecessary duplication or unnecessary facilitation of the shareholders and the Fund by MLPF&S. The issue here is not whether the servicing requirements are to be labeled a "conduit" service or a "funneling service" or otherwise, but whether objectively, those services and their estimated costs may be considered in evaluating the fairness of the amounts paid as contingent compensation by the Fund. The factual answer on this record is clearly in the affirmative.

The possibility that institutions in which the Fund invests might reciprocate by placing brokerage business with Merrill Lynch is mere speculation on the part of plaintiffs. There has been no showing that such reciprocal arrangements exist, or that their value can be estimated.

Finally, the fact that Merrill Lynch Government Securities, Inc. receives a dealer spread on transactions with the Fund has been disclosed in every proxy statement for the past three year, as well as in booklets given annually to the Trustees for at least the past four years.

In short, only conclusory assumptions, not evidence, supports the theses of offsetting benefits adduced by plaintiffs. The testimony of the independent Trustees adequately indicates their appreciation

and understanding of the picture, as well as the fact that they were not expected to evaluate the compensation paid on a cost-plus basis by taking into account the nebulous offsets pressed by the plaintiffs. The citation by plaintiffs of cases of abuse of a Fund's assets have no relevancy here. Contrast Steadman v. S.E.C., 603 F.2d 1126 (5th Cir. 1979), aff'd 450 U.S. 91 (1981).

The Approval of the Advisory Agreement by the Trustees

Section 36(b) instructs the courts to give director and shareholder approval of advisory compensation arrangements "such consideration...as is deemed appropriate under all the circumstances." 15 U.S.C. §80a-35(b)(2)(1976). In weighing the approval by the Trustees, this Court must keep in mind that "the structure and purpose of the [Act] indicate that Congress entrusted to the

independent directors of investment companies...the primary responsibility for looking after the interests of the funds' shareholders." Burks v. Lasker, 441 U.S. 471, 484-85 (1979).

The facts in this case demonstrate that the approval of the advisory fee by the board of trustees of the Fund should be weighed heavily, since the Trustees gave careful consideration and were adequately informed at all times of the structure and price being paid by the Fund, the going price in the market of comparable services, the scope of the services rendered, the performance achieved, the nature of the costs of the services supplied, their estimated value and the profitability of the contract overall. The Trustees knew and considered the alternatives available and the hypothetical value of the contract to

the Merrill Lynch organization as a whole.

A. The Identity and Experience of the Non-Interested Trustees

The board of trustees of the Fund consisted of eight Trustees, six of whom are non-interested within the meaning of the Investment Company Act. The non-interested Trustees are men of maturity and substantial stature with singular qualifications and experience in diverse fields, having held positions of importance in the world of business, finance, investment and education. All have had responsibilities and experience in some form of securities portfolio managemenet. Their independence and their competence as trustees were not questioned or questionable herein and they have been free of domination or undue influence by MLAM and its affiliates.

B. <u>The Attention of the Trustees was Fixed on Their Responsibilities</u>

In the Senate Report, at page 7, the following is noted:

> The bill also contains provisions which are designed to assist directors in discharging their responsibilities. Included is a proposal that the directors must request and evaluate, and that the investment adviser must furnish to them, such information as is reasonably necessary to evaluate the terms of the management contract. Thus, the attention of the directors will be fixed on their responsibilities.

Accordingly, the MLAM directors were told in the memorandum to independent Trustees dated April 15, 1981 (like information was furnished in earlier years) that in reviewing and approving the agreement with MLAM and MLFD:

> As the independent Trustees you bear the principal responsibility for evaluating the advisory and distribution agreements, determining their reasonableness and considering the available alternatives from the standpoint of the best interests of the Trust and its shareholders.

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> In making the necessary determinations and findings it is essential that you have adequate information upon which to make reasonable judgments.

Having thus been alerted, the independent Trustees were told that the courts have interpreted Section 15(c) of the Act to require a substantial degree of inquiry, knowledge and critical judgment on the part of fund directors; that Section 36(b) provides that investment advisers have a fiduciary duty with respect to the receipt of compensation for services and provides an express cause of action for recovery of excessive management compensation.

It was emphasized to the Trustees that "<u>[i]n making their determination in this area, the independent trustees must be fully informed in an impartial manner of all relevant factors with respect to the advisory agreements and, after a</u>

thorough review of all relevant factors, must reach agreement with the Fund's investment adviser on the basis of arm's length bargaining." (Emphasis in original). They were told that the major consideration would be their analysis of the reasonableness of the proposed advisory fee under prevailing facts and circumstances. To underscore this mention was made of the fact that two suits were already pending affecting the Fund. These were reviewed and their contentions exposed; namely, that the charges against MLAM included breach of fiduciary duty by receiving advisory fees which were excessive and disproportionate to the services rendered and that the proxy statements to the shareholders misrepresented the benefits of economies of scale and failed adequately to disclose the costs of the investment adviser.

Attention was called to the fact that the advisory agreement in its present form was to be continued for an additional year, being the identical agreement theretofore approved by the Trustees as well as by the shareholders in 1979 and 1980.

Attention was drawn to the fundamental alternatives to the MLAM proposal to be kept in mind, such as internal management or seeking a different investment adviser; the scope of the services provided by MLAM and its affiliates; and an analysis of the proposed advisory fee.

C. The Trustees' Deliberations

The record establishes tht the Trustees were supplied with information sufficient to enable them to evaluate the advisory contract with an eye willing and capable of discerning the interests of the Fund, including the

bargaining power generated by the Fund's enormous size. <u>See</u> <u>Fogel v. Chestnutt,</u> 533 F.2d 731, 749 (2d Cir. 1975), <u>cert denied,</u> 429 U.S. 824 (1976). The Adviser fully complied with the duty of full disclosure required of it by Section 36(b). <u>See</u> <u>Galfand v. Chestnutt,</u> 545 F.2d 807, 811 (2d Cir. 1976); <u>Fogel, supra,</u> 533 F.2d at 745; <u>Moses v. Burgin</u>, 445 F.2d 369, 377-78 (1st Cir.), <u>cert.</u> <u>denied</u>,404 U.S. 994 (1971); <u>Papilsky v. Berndt,</u> [1976-1977] Fed. Sec. L. Rep. (CCH) ¶95,627, at p. 90,132 (S.D.N.Y. 1976). <u>Cf.</u> <u>Tannenbaum v. Zeller,</u> 552 F.2d 402, 417 (2d Cir.), <u>cert. denied,</u> 431 U.S. 934 (1977)(§36(a)).

As indicated previously, attention herein must be focused ultimately upon the Trustees' meetings of April 24, 1980 and May 7, 1981, at which the Trustees renewed the fee schedule according to which the disputed payments were made.

First, throughout the period with which this suit is concerned, the Trustees received weekly reports regarding the operation of the Fund. These reports contain a summary of the number of new shares issued, the number of shares redeemed during the week, as well as the change in the Fund's asset value during the period. The report also states the annualized dividend return along with the current portfolio yield.

Second, before each quarterly meeting the Trustees received "agenda booklets." These reports include a summary of developments in the economy, a description of the Fund's portfolio transactions, a summary of performance data for similar funds, and descriptions of the yield and structure of the Fund's portfolio. In the agenda booklets, the Trustees were provided with the materials to gain a clear portrait of the phenomenal growth

of the Fund: figures were displayed by month for the number of shareholders, the Fund's net assets and the volume of Fund orders processed through MLPF&S. The quarterly report for January 30, 1980 given at the meeting held on that date summarized the 1979 reimbursement by MLAM to MLPF&S for processing orders of the investors in the Fund.

Third, several weeks before every annual meeting each Trustee was provided with a "Trustee booklet." The booklet for the meeting of April 24, 1980 is over 200 pages long. It contains a comprehensive memorandum from counsel for the Fund discussing, among other things, the statutory role of the Trustees and the issues to be discussed at the annual meeting, and includes a statement of alternatives to the MLAM advisory fee proposal. The Trustee booklet for the 1980 meeting also

It will be useful, however, to refer to earlier meetings in order to place the Trustees' consideration of the fees in its proper context.

Since January 1977, the non-interested Trustees of the Fund have been represented by independent counsel. The independent Trustees by themselves constitute the Audit Committee of the Fund. Typically, before the annual meeting of the board of trustees, the independent Trustees meet as the Audit Committee to consider the appropriateness of the advisory agreement.

An impressive amount of documentary material was furnished to the Trustees so that they could carry out their responsibilities in considering the fairness of the advisory agreement. A summary of the material shows its comprehensive scope.

includes the number of shareholder accounts being serviced, the number of orders being processed for investors, profitability statements of MLAM, copies off the investment advisory and distribution agreements as well as data comparing the Fund's advisory fee, performance and operating expeses and expense ratios with those of other funds, and a description of the Fund's portfolio transactions, including those as principal with Merrill Lynch Government Securities, Inc. Lastly, the 1980 booklet sets forth data regarding Merrill Lynch's costs in processing Fund orders, as well as information regarding SEC proposals for regulating the use of Fund assets for distribution.

The Trustee booklet for the meeting of May 7, 1981 was over 250 pages long. As well as containing the types of information as in the Trustee booklet

for the previous year, the 1981 booklet included an opinion of Fund counsel as to the propriety of taking account of MLPF&S's processing costs in considering the fairness of the advisory fee, along with the recent SEC Rule 12b-1 and accompanying Release No. 11414 governing distribution costs, and a memorandum by Fund counsel discussing the decision-making process in the investment company area.

The question of the costs to the Merrill Lynch organization as a whole from the operation of the Fund had "surfaced...in 1977,...but it became a matter of continuing and more intense concern after April 1978." (Tr. at 254).

The question of costs sparked an internal accounting debate within the Merrill Lynch organization as to how to measure the costs to Merrill Lynch

associated with the operation of the Fund. The evidence shows that the Trustees were kept fully informed of Merrill Lynch's progress in coming up with solid figures concerning the costs associated with Fund transactions.

As early as the meeting of May 8, 1979, the Trustees were informed of the existence and results of the Diemer study of processing costs. In his presentation to the Audit Committee on that day, Arthur Zeikel, president of MLAM, reported that a preliminary study indicated that the costs to MLPF&S associated with Fund transactions were about $5 per order. Zeikel stated that "he could not evaluate the accuracy of the study, that many assumptions were included therein and that he expected the figures to be further refined.[24]

24./ All quotations in this section, unless otherwise identified, are from the minutes of the meetings.

He further noted that "each subsidiary of Merrill Lynch & Co. operates as a separate profit center and that MLAM was under considerable pressure to compensate MLPF&S for its costs."

The independent Trustees were then given a memorandum prepared by counsel for the Fund which advised them that they could consider the expenses of MLPF&S in determining the fairness of the advisory fee if they determined: 1) that MLPF&S's services benefited the Fund, 2) that those services are responsible for the Fund's present success, and 3) that there is no adequate substitute for the services. However, counsel to the independent Trustees pointed to a question that had been raised, "that processing costs could be considered to be distribution expenses." After reviewing the position of the Securities and Exchange Commission on

this matter, he concluded that "it was far from certain as to whether distribution expenses could be considered in fixing an advisory fee."

The legal advice concerning the processing costs was conservative and neutral and sufficiently indicated the legal uncertainties involved. It was sound adequate advice which permitted an independent consideration and evaluation of the fee agreement by the Trustees and its relation to the total compensation payable by the Fund for services.

The independent Trustees asked how much the services of MLPF&S benefited the Fund and to what extent the services could be purchased elsewhere. MLAM's corporate counsel replied that while there would only be a "modest" increase in the fees of the Transfer Agent if MLPF&S were not employed, the Transfer Agent would not provide the access for

shareholders that desirable and provided by MLPF&S. And Zeikel noted that "[e]xpenses to facilitate shareholder orders, in one form or another, are essential for the successful operation of money market funds."

The summary of the discussion at the May 8, 1979 Audit Committee meeting shows that it was becoming clear to Merrill Lynch that Fund transactions were resulting in substantial, mounting expenses to MLPF&S. Nonetheless, MLAM at the time voluntarily proposed an additional breakpoint in the fee schedule of a rate of 0.275% of average assets over $2.5 billion. This was in line with discussion at the meeting that "recognized that MLAM's profits from advising the [Fund] subsidize MLAM's other operations."

Zeikel stated "that MLAM would continually monitor its operations during

the year and discuss possible further breakpoints during the year if deemed feasible."

The independent Trustees, as the Audit Committee, then considered the fee paid to the Adviser. They noted that:

1. There could be no direct comparison with other money market funds since the Fund was so large.

2. Much of the success of the Fund was due to the efforts of MLAM and MLPF&S and "they certainly were entitled to an ample profit for their endeavors."

3. From the point of view of its expense ratio and the impact of the fee on the shareholder, the fee was not excessive.

"The [independent] Trustees agreed that, while they were uneasy about the profits to MLAM, they would approve the proposed fee subject to periodic review during the year." The fee was consequently approved by a unanimous vote of the Trustees at the full board meeting which followed that of the Audit Committee.

Internal documents in June 1979, record Zeikel's disputed opinion that the $5 per order estimate prepared by Diemer had overstated the burden on MLPF&S of the Fund's processing costs. Shareholder orders were running at this time at the annual rate of 2,143,176.

At the July 25, 1979 meeting of the board of trustees, they received information of the filing of Gartenberg's suit, which had been commenced on June 14, and were told of that shareholder's contentions.

Zeikel evidently waited to present to the Trustees the dispute between himself and MLPF&S over the amount of the processing burden created by the Fund until he had some figures to support his opinion. The Fitz-Gerald estimate, which found the Fund's burden on MLPF&S to be significantly lower than the $5 per order estimate urged by Diemer, was ready in late August. At the following

Trustees' meeting, on October 24, 1979, Zeikel told the Trustees that the cost studies he had received placed the processing cost to MLPF&S at either $5 or $2 per order. He noted that the results of the studies were not final. Shareholder orders were meanwhile zooming upward and were running in a monthly quantity annualized at 4,013,688.

At the same meeting, Mr. Ross, one of the interested Trustees, stated that he had been given the authority to allocate costs between MLAM and MLPF&S. He thought that insofar as total costs to the organization were concerned, the $5 per order figure would be firm. He also argued "that the fee schedule should be based on the total cost to the Merrill Lynch complex for providing the services and not the internal allocation of costs between MLAM and MLPF&S."

Zeikel noted that if the $5 per order figure was correct, "then the profitability to MLAM and MLPF&S would be thin at the present fee levels;" consequently, continued fee reductions at regular intervals would reach the point where MLAM would lose money.

On November 1, 1979, Zeikel sent copies to the Trustees of the memos that had come up with the $5 and $2 per order figures. He also informed the Trustees that a complaint had been filed in the Andre case on October 23, 1979.

The intracompany charge between MLPF&S and MLAM as estimated by the staff was expressly discussed at the Trustees' meeting held on January 30, 1980. The final arrangements for the 1979 reimbursement of MLPF&S to MLAM totalled $5,059,712, using Fitz-Gerald's cost estimate of $3 each for the first 500,000 transactions, $2 each for the

next 500,000 and $1.50 for the remaining 1,446,475 added to direct costs to MLPF&S of $390,000.

The sharp upward spike of orders being processed in 1980 and 1981 was reported to the Trustees in monthly figures given in the quarterly reports. The range of the internal and external studies of the processing costs on a per order basis were discussed with the Trustees. The arithmetical results of the costs multiplied by the order volume were obvious.

At the Trustees' meeting on January 30, 1980, PMM reported on their preliminary study of Fund processing cosats, specifically, those Merrill Lynch costs in the third quarter of 1979 that were attributable to services provided for shareholders of the Fund.[25/] Their

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25/ PMM had been retained in connection with the Gartenberg suit.

report placed the approximate cost of processing ordrs during this particular quarter at $9.74 apiece. In light of the PMM report, MLAM decided not to adjust the advisory fee and the Trustees agreed.

The Audit Committee minutes for the meeting of April 24, 1980 contain an extensive description of the discussion at that time concerning the advisory fee agreement, servicing and processing costs, Fund performance, expense ratio, revenues and profits to MLAM.

The Committee considered:

1. the service, operation and personnel of MLAM in relation to the Fund's activities and requirements, including servicing and processing provided by MLPF&S.

2. the Fund's portfolio performance in general and in relation to other money market funds, noting the complexities of managing and investing such a large amount of money.

3. the Fund's fee structure and expense ratio compared to the rest of the industry.

4. the sizeable revenues and profits to MLAM.

The counsel for the independent Trustees discussed their responsibilities with them. He thought it would be preferable at the time to reach a decision about the advisory fee "without significant regard to" the costs of shareholder services and processing provided by Merrill Lynch until the PMM study was completed. "[H]e recommended, therefore, that little or no weight be given to the preliminary cost data which had so far been furnished to the non-interested Trustees."

The option of an additional breakpoint in the fee schedule was raised and rejected.

According to the Audit Committee minutes:

> The Committee also discussed the potential benefits to Merrill Lynch of the interface with the [Fund] which gave rise to the

> principal shareholder servicing and processing activities of Merrill Lynch, including new account opportunities and continued influence over the investment of Merrill Lynch customer assets.

The Committee also considered and rejected the option of switching investment advisers or internalizing the management of the portfolio.

At the full meeting of the board of trustees, the continuation of the present fee schedule was approved after the Trustees heard PMM's second presentation regarding the Fund's processing costs. That presentation indicated a cost estimate in the $7 per order range for the first quarter of 1980. Mr. Cecil, a non-interested Trustee, mentioned that "MLAM had done an exceptional job in terms of performance for the shareholders of the [Fund]."

The last meeting that the record describes is the most recent annual

meeting held on May 7, 1981. Again, the Trustees' deliberations are portrayed in a detailed manner.

Mr. Zeikel described the burdens that the "runaway phenomenon" of recent Fund growth had put on the Merrill Lynch organization. The Fund had grown to 1,100,000 shareholders, "almost all" of whom had acquired their shares through MLPF&S, and the net assets of the Fund under supervision and servicing were $17 billion.

Approximately 30% of these shareholders "do no business with Merrill Lynch other than purchasing and redeeming [Fund] shares and...the transaction and information demands of the [Fund's] shareholders imposed enormous physical and financial burdens on Merrill Lynch's systems and operations and on Merrill Lynch's account executives."

"[T]his high level of activity was customer driven and...no organized promotion of the sale of [Fund] shares or share distribution effort on the part of Merrill Lynch or the Distributor was taking place."

Zeikel noted that Fund transactions constituted 37% of all transactions processed by Merrill Lynch. This made the costs of processing Fund shares too great to be analyzed on an incremental basis, but quantifying them exactly was impossible. However, not only did Merrill Lynch's and PMM's studies show that the costs involved were large, but significantly, so did the fact that Merrill Lynch had added approximately 3,000 non-sales personnel to handle the additional transaction volume.

While Mr. Armstrong -- an independent Trustee -- raised the possibility of instituting another breakpoint in the

fee schedule, most of the independent Trustees seemed to find little basis on which to do that. Mr. Cecil and Mr. Meyer remarked on the low number of customer complaints with the Fund, despite reports that account executives were dissatisfied with it since the work they did for the Fund generated no commission revenue for them. Mr. Cecil also remarked on the excellent yield of the Fund. Finally, Mr. James pointed out that

> it was clear that substantial processing and servicing costs were being incurred by Merrill Lynch on account of the [Fund], even though it appeared impossible to ascertain their magnitude.
>
> [He] said that these costs had to burden profitability from the Investment Advisory Agreement, and he thought it would be a mistake to push too far on the profitability issue in view of the excellent job MLAM was doing in handling the [Fund's] extraordinarily large assets and number of shareholders.

The lawyer for the independent Trustees then recommended that the Trustees could properly take Merrill Lynch's processing costs into account in considering the reasonableness of the fee. This advice, which constituted a modification of his previous opinion on the matter, was a result of SEC Release No. 11414, promulgated in late 1980, which had for the first time clarified and established the definition of prohibited distribution as "activity which is primarily intended to result in the sale of [investment company] shares."

The Audit Committee then considered the fee in light of:

1. the services provided by Merrill Lynch and MLAM.

2. the Fund's portfolio performance in general and in comparison to other funds.

3. the Fund's fee structure and expense ratio in general and in relation to other funds.

4. the sizeable revenues and profits to MLAM.

5. the possible benefits to Merrill Lynch.

The Audit Committee also considered and rejected the possibility of switching or internalizing the management of the Fund.

At the full board meeting the advisory agreement was discussed and approved for another year without any changes in the fee schedule.

Summary

The Court's evaluation of the testimony of the Trustees who took the stand and a close examination of the records of the Trustees' meetings demonstrates that their attention was properly focused on their obligations regarding the compensation to be paid to MLAM. They were made aware of the scope of the net assets under supervision and how they were being administered. They were

made aware of the performance of the Adviser under its agreement and of the ratio of expense to the size of the Fund. They were furnished with comparable data concerning other money market funds and they were given prompt and complete information relevant to the services being supplied by the Merrill Lynch system including the Fund's processing burden on MLPF&S. They had the information to appraise the revenues and net profitability of servicing the assets.

The non-interested Trustees were represented by their own independent counsel at the meetings, who acted to give them conscientious and competent advice. The discussion concerning the advisory agreement and the processing costs appear to have been frank and open, and belie any contention that the Trustees were dominated by the Adviser. The Trustees exercised an informed

judgment in good faith and upon a reasonable basis.

It is appropriate, therefore, to weight heavily the approval of the investment advisory agreement by the Trustees on April 24, 1980 and again on May 7, 1981 in determining the fairness to the Fund of the compensation which it paid.

In the summer of 1981, the independent Trustees had the opportunity again to consider and expressly approved the schedule of compensation to MLAM. On that occasion every argument and its minutiae made now by the plaintiffs was fully before the Trustees. The occasion was the plaintiffs' demand on July 14, 1981 (for the first time) that the Trustees commence this suit.[26/]

26/ At the hearing of September 4, 1981, counsel for plaintiff Andre confessed that he had started the suit in error without a demand; he had not realized that the suit required such a demand.

No claim could thereafter be made that the Trustees lacked this or that piece of information as now thrust into this record or were misled in their consideration of the compensation. All of the plaintiffs' selective analyses and convenient inferences were made to and turned aside by the Trustees. This was not "post litem motam" consideration. It was an evaluation made after depositions had been taken on a specific complaint and proposed findings of fact which were prepared and ventilated by plaintiffs in these lawsuits. This was not merely, as Andre would have it, a post hoc reconstruction of mental processes to remedy defective disclosures.

The Shareholders' Consideration of the Fee

The shareholders of the Fund have approved every advisory fee agreement that has been entered into betweem MLAM

and the Fund. In this case, shareholder approval may be given some, but not substantial weight, in determining whether or not MLAM has complied with its fiduciary duties.

As is apparent from the portion set forth in the margin, the proxy statements for the shareholders' meetings of August 7, 1980 and August 6, 1981 stated clearly that the present suits had been filed and that they challenged the fairness of the advisory agreement and mentioned the grounds asserted.27/

27/ The proxy materials stated:

> MLAM has been named as a defendant in two derivative actions, commenced by two individual shareholders in June and October, 1979, respectively, on behalf of the [Fund] in the United States District Court for the Southern District of New York. Both complaints charge that the Investment Adviser has breached its fiduciary duty to the [Fund] by charging advisory fees which are excessive and disproportionate to the services rendered by MLAM. One

The same proxy materials clearly detailed MLAM's advisory fee both as a percentage of the Fund's assets and as an annual aggregate amount. The materials also estimated the amount that would be paid to MLAM by the end of the calendar

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Footnote 27/ continued:

> of the complaints alleges, in addition, that the Fund] has borne certain expenses that should have been borne by MLAM, that the growth of the net assets of the [Fund] has damaged the [Fund]by making it difficult or impossible for the [Fund] to take advantage of short-term changes in interest rates and that the July 30, 1979 proxy statement sent by MLAM to shareholders of the [Fund] misrepresented to shareholders the benefits to them of economies of scale and failed adequately to disclose the costs of MLAM incurred with respect to the [Fund], thus rendering null and void the approval by the shareholders on September 14, 1979 of the present investment advisory contract. Both complaints seek the return to the [Fund] of the allegedly excessive advisory fees paid to the Investment Adviser and one seeks, in addition, to enjoin the [Fund] and the Investment Adviser from continuing the allegedly unlawful conduct.

year.[28/]

Against these revenues, the proxy statements noted that the agreement

> obligates the Investment Adviser to provide investment advisory services, to furnish administrative services, office space and facilities for management of the [Fund's] affairs, to pay all compensation of officers of the [Fund] as well as Trustees of the [Fund] who are affiliated persons of Merrill Lynch & Co., Inc. or its subsidiaries, and to bear the cost and expenses of advertising of the [Fund].

The aggregate amount of MLAM's expenses was not set forth in the proxy statements, which is not surprising since the proper way in which to take account of these costs was a hotly debated topic during this period. Moreover, the statements did not advise the shareholdsers (as the Trustees were

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28/ The estimate for 1980 was $33 million, only $98,456 less than the actual amount paid. The estimate for 1981 is $47.6 million.

advised) that the costs to MLPF&S of processing Fund orders and servicing accounts might properly be weighed in considering the fairness of the fee agreement.

The shareholders of the Fund would not have been likely to have charged their votes if additional information regarding those costs had been included. Such information could only have strengthened the evidence of the fairness of the fee. It was not a breach of fiduciary duty for the proxy statements to understate Merrill Lynch's case.

Each of the proxy statements referred to above reported to the shareholders that the Trustees had approved the continuance of the Investment Advisory Agreement for a period of one year and that:

> In their consideration of this matter, the Trustees considered the extensive information relating to, among other things, alternatives to the MLAM arrangements, the [quality], extent and value of the services provided to the Trust by MLAM and its affiliates (including Merrill Lynch), comparative data with respect to the advisory and management fees paid by similar [other than money market] funds, the operating expenses and expense ratio of the Trust as compared to similar [such] funds, the performance of the Trust as compared to the performance of similar [other money market] funds and data relating to the costs incurred by MLAM and its affiliates in providing advisory, administrative, processing and other services to the Trust and its shareholders.

In sum, since the Investment Company Act contemplates that the primary responsibility for ascertaining the most significant matters is laid on the Trustees, Burks v. Lasker, 441 U.S. 471, 484-85 (1979), the approvals by the shareholders are to be noted in their review of compensation accepted by MLAM, but no significant weight is needed

therefrom to vindicate the fairness of the compensation.

The Attempted Expansion of Issues

The complaints in these suits allege but one cause of action -- a claim for breach of fiduciary duty under Section 36(b) of the Act, 15 U.S.C. §80a-35(b) (1976). In a diversionary belated attempt, Andre had sought to suggest additional claims herein after the plaintiffs had rested. We shall deal with them only for the sake of completeness, albeit they were dismissed at the close of the case as lacking merit, not asserted and not proved.

MLPF&S does not furnish any advisory services to the Fund regarding the investment of its portfolio. Section 15(a) of the Act, 15 U.S.C. §80a-15(a) (1976), calling for a written contract between an adviser and a fund is therefore

inapplicable to MLPF&S. See Teachers Association Mutual Fund of California, Inc. [1971-1972] Fed. Sec. L. Rep. ¶78,582 (S.E.C. 1971)(no action letter).

MLPF&S is not a "principal underwriter" as defined by section 2(a)(29) of the Act, 15 U.S.C. §80a-2(a)(29)(1976), and is not obligated to act in its processing function pursuant to a written contract with the Fund. A dealer who makes purchases from an open-end fund through a principal underwriter acting as agent for the fund is not included in the statutory definition of a principal underwriter. Consequently, the contract requirement of Section 15(b) of the Act, 15 U.S.C. §80a-15(b)(1976), does not apply to MLPF&S.

It is clear on the face of the definitional statute that MLPF&S cannot qualify as a principal underwriter and

thus is not subject to Section 15(b). There is no privity of contract between the Fund and MLPF&S which would make MLPF&S a principal underwriter of the shares of the Fund. The only entity in direct privity of contract with the Fund for the purpose of selling its shares is MLFD, which is the Fund's principal underwriter.

The Distribution Agreement with the Fund, an agreement which complies with Section 15(b), describes and appoints MLFD specifically as "the exclusive representative of the Trust to act as principal underwriter", with exceptions not relevant here. The Distribution Agreement gives MLFD the right to have shares of the Fund "re-sold" by its securities dealers, of whom MLPF&S is one, as noted previously. Although MLPF&S sells shares to the public it does not purchase or have the right to

purchase them directly for the Fund. It purchases shares through MLFD as agent for the Fund. The system used by the Fund was clearly and correctly explained at trial by Mr. Edgar M. Masinter, counsel for the independent Trustees, and has long been typical in the mutual fund industry. See United States v. National Association of Securities Dealers, Inc., 422 U.S. 694, 698-99, 706 (1975); Report [by the S.E.C.] on the Public Policy Implications of Investment Company Growth, H.R. Rep. No. 2337, 89th Cong., 2d Sess. 9, 54-56 (1966).

MLAM has, as heretofore found, satisfied its duty to furnish such information as was reasonably necessary for the Trustees to evaluate the terms of the advisory contract and has thus satisfied Sectin 15(c) of the Act, 15 U.S.C. §80a-15(c)(1976).

Andre's claim that misleading and insufficient materials were disseminated to shareholders of the Fund in violation of Section 20(a) of the Act, 15 U.S.C. §80a-20(a)(1976) is the product of a fertile imagination. Rule 20a-1, 17 C.F.lR. §270.20a-1 (1981), promulgated by the SEC under the authority of that section, adopts the requirements of Rule 14a-9, authorized by the Securities Exchange Act of 1934. That Rule forbids solicitation by means of any proxy statement "which omits to state any material fact necessary to make the statements therein not false or misleading...." 17 C.F.R. §240.14a-9 (1981). As the Supreme Court has stated:

> An omitted fact is material is there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote....Put another way, there must be a substantial likelihood that the disclosure of the

> omitted fact would have been viewed by the reasonable investor as having significantly altered the "total mix" of information made available. TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976).

As already mentioned, since shareholder votes would not have been affected by details of costs, none of the points made involve material matter for purposes of this kind of case and the disclosure was ample in view of the burden placed on and satisfied by the Trustees.

In any event, Sections 15(b), 15(c) and 20(a) of the Act were not intended to and do not establish a private right of action in the context of a claim such as here for recovery of compensation under Section 36(b). The structure of the Act makes clear that no private remedies other than Section 36(b) seeking restitution of advisory fees shall be implied, brought or maintained and no other relief shall be granted

against the recipient of the payments made. Section 36(b) affords the complete remedy intended by Congress. "Congress amended the Investment Company Act in 1970 to create a narrowly circumscribed right or [sic] action for damages against investment advisers to registered investment companies." Transamerica Mortgage Advisors, Inc. v. Lewis, 444 U.S. 11, 22-23 n.13 (1979) (Emphasis supplied).

Contrasting the question here from that of recapturing brokerage commissions, Judge Friendly has recently indicated in Fogel v. Chestnutt, Nos. 80-7800, 80-7804, slip op. at 488 (2d Cir. Dec. 17, 1981)(Fogel II): "we might agree... that §36(b), with the severe limitation of subsection (3), constitutes the exclusive remedy insofar as a private claim alleges solely that compensation of an adviser subsequent to June 14,

1972, the effective date of §36(b), is so excessive in the sense of surpassing any reasonable relation to the services rendered that its payment is a breach of fiduciary duty." (Emphasis supplied).

The latterly constructed claims have no merit.

Perspective

Money market shareholders hold the key to the continuance of the Adviser in charge of their funds. They can terminate the relationship simply by writing a check and redeeming at once. This is the strongest kind of bargaining power against compensation that is improper. Each year has brought into the market place a new crop of funds with their compensation levels to choose from. The price charged by advisers to those funds establishes the free and open market level for fiduciary compensation. The

shareholder can without cost to himself or any other disadvantage deal with numerous suitable others in the market place freely and voluntarily. _See_ Frankel, _Money Market Funds,_ 14 Rev. Sec. Reg. 913, 918 (1981).

Under our political system no ceilings have been placed on making money except in regulated, public utility areas. In the circumstances presented by this case, the control of fiduciaries by courts requires of them fairness, openness and good faith; not the leveling of the monetary rewards of an entrepreneurial activity. The market price -- freely available and competitively set -- serves as a standard to test the fairness of the investment advisory fee under the facts shown in this record.

Conclusions

A money market fund is not a public utility. It does not obtain an exclusive territory in which to operate. It provides, at its own risk, in a market freely available to unlimited competitors, the services of organizing and pooling small amounts to produce the advantages received by the shareholders, including the ability to deposit and withdraw funds without cost, providing only that withdrawal checks be $500 or over.

The money market fund industry is a highly competitive business. There is no monopoly. There is no limited entry. There has been ample disclosure by the Adviser of the rate of fees to prospective customers, shareholders, the Fund and its Trustees.

How much is too much to compensate such services and facilities? To date there has never been an introduction in

the economic system of this country of the concept of profit regulation in a non-utility business, which is neither a protected industry, nor exempt from the antitrust laws. In such businesses reliance is placed on the normal forces of the economic system for rate control.

The issue of fair compensation becomes ultimately a social or philosophical -- and hence a legislative question -- when the fee is in harmony with the broad and prevailing market choice available to the investor, the price being paid is disclosed and the services are satisfactorily performed and sufficient disclosure of the scope of the enterprise, its requirements and performance is made to the Fund's directors and investors. As Mr. Justice Collins appositely wrote many years ago in Heller v. Boylan, 29 N.Y.S.2d 653, 669 (Sup. Ct.), aff'd 263 App. Div. 815,

32 N.Y.S.2d 131 (1st Dep't 1941): "[T]he particular business before this Court is not the revamping of the social or economic order." There would seem to be no sense to seek to limit by judicial fiat what is satisfactorily performed, sufficiently disclosed and freely available elsewhere in the market place at comparable charges, without penalties or restraint.

The Adviser is expected to supply either by itself or import the requisite investment, administrative and processing services. The greater the demand that there is for these services because of the volume of orders that accompany the proliferation of shareholder accounts, the larger and costlier must be the facilities made available to cope with them. MLAM has shared with the Fund those economies of scale that it has

realized from the Fund's growth and size.

The huge cost of processing large quantities of customer orders in the redemption and deposit services offered to shareholders cannot be reasonably ignored. Nor could fiduciary obligation rationally be required to overlook the unavoidable costs of reducing gross revenues to net profitability therefrom. If the Adviser is to act as an independent contractor and not a mere employee, a sense of reality requires that the compensation to be judged be reduced to its net benefit after all costs incurred in supplying the services required.

Based on the rate of payment alone, the rate of compensation received by the Adviser herein is neither extraordinary nor uncommon but is a commercially realistic rate. The compensation paid by the Fund is high as a matter of

numbers but the payment is lawful relative to the gargantuan size of the Fund. The fees bear a fair relation to the subject matter from which they are derived. There is "shocking disparity" between the fees paid when compared to compensation to other persons or firms performing the same kind of services in a comparable situation. The diminution in cost factor from increased size is not applicable to the year under review or, if it is, it is insignificant in view of the burdens of scale that have been demonstrated rather than the theoretical economies of scale of which there is no evidence.

The plaintiffs have not sustained their burden of proof of establishing under governing legal standards that the fees received should be characterized as a breach of fiduciary duty.

The complaints are dismissed, on the merits.

The foregoing shall constitute the findings of fact and conclusions of law required by Federal Rule of Civil Procedure 52(a).

SO ORDERED

December 28, 1981

Milton Pollack
United States District Judge

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

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IRVING L. GARTENBERG,

Plaintiff, — 79 Civ. 3123 (MP)

v.

MERRILL LYNCH ASSET MANAGEMENT, INC., MERRILL LYNCH, PIERCE, FENNER & SMITH INCORPORATED, and MERRILL LYNCH READY ASSETS TRUST,

Defendants.

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SIMONE C. ANDRE,

Plaintiff, — 79 Civ. 5726 (MP)

v.

MERRILL LYNCH READY ASSETS TRUST and MERRILL LYNCH ASSET MANAGEMENT, INC.,

Defendants.

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DECISION

MILTON POLLACK, District Judge.

These cases are shareholders' derivative suits on behalf of Merrill Lynch Ready Assets, Trust, alleging that its investment advisor, Merrill Lynch Asset Management, Inc., violated Section 36(b) of the Investment Company Act, 15 U.S.C. sec. 80a-35(b), which imposes a fiduciary duty on investment advisors with respect to their compensation. The question presented is whether the suit should be dismissed because of the plaintiffs' failure to demand of their board of trustees that the Trust pursue a remedy in its own name.

Federal Rule of Civil Procedure 23.1, which governs shareholders' derivative actions in the federal courts, does not require that a demand on directors (or trustees, in this case) be made in every case. Rather, the rule requires that there be a demand or a proper excuse for the failure to demand.

Both Gartenberg and Andre failed to demand action by the board of trustees before their suits were commenced. Though Gartenberg's amended and supplemental complaint mentions no reason why he failed to file a demand with the trustees before filing suit, Andre's complaint states that demand was excused because the trustees could not initiate any action under Section 36(b), and that two of the eight trustees were interested in the defendant investment advisor. Andre Complaint, para. 13.

On July 14, 1981, more than two years after Gartenberg had filed suit, and four months after filing agreed and disputed proposed findings of fact and conclusions of law, Gartenberg's counsel formally demanded action from the trustees. The trustees rejected the demand on August 12, 1981, and elected not to pursue any claim against the investment advisor; it was the "judgment of the disinterested trustees...that the advisory agreements...were in accordance with the law and have served the best interests of the Trust."

Behind the demand or excuse requirement of Rule 23.1 lies the "notion that a shareholder's suit is to be resorted to as a last alternative, and that the corporation is given every possibility to sue in its own name." 3B J. Moore, Moore's Federal Practice para. 23.1.19, at 23.1-82 (2d ed. 1980). See 7A C. Wright & A. Miller, Federal Practice and Procedure sec. 1831, at 374 (1972). It recognizes that it is ordinarily the job of the directors to govern the corporation. Delaware & Hudson Co. v. Albany & Susquehanna R.R. Co., 213 U.S. 435, 29 S.Ct. 540, 53 L.Ed. 862 (1909); In re Kauffman Mutual Fund Actions, 479 F.2d 257 (1st Cir. 1973), cert. denied, 414 U.S. 857, 94 S.Ct. 161, 38 L.Ed.2d 107 (1973). See Note, The Demand and Standing Requirements in Stockholder Derivative Actions, 44 U.Chi.L.Rev. 168, 171 (1976). It is also the job of the directors to consider whether there was performance of fiduciary duty before a stockholder may plunge the fund into litigation on this question.

In this case, plaintiffs filed a demand on the trustees more than two years after filing their complaints. Several recent cases in the Third Circuit have held that a late demand is insufficient to satisfy the requirements of Rule 23.1. See Cramer v. General Tel. & Elec. Corp., 582 F.2d 259, 276 (3d Cir. 1978), cert. denied, 439 U.S. 1129, 99 S.Ct. 1048, 59 L.Ed.2d 90 (1979). ("the futility of making the demand required by Rule 23.1 must be gauged at the time the derivative action is commenced, not afterward with the benefit of hindsight."); Shlensky v. Dorsey, 572 F.2d 131, 142 (3d Cir. 1978); Weiss v. Temporary Investment Fund, Inc., 516 F. Supp. 665 at 673 (D.Del. 1981). Other cases in this Circuit, however, have allowed plaintiffs to make a later demand and file an amended complaint. See Markowitz v. Brody, 90 F.R.D. 542 (D.C.N.Y. 1981); Siegel v. Merrick, 84 F.R.D. 106, 110 (S.D.N.Y. 1979). See also de Haas v. Empire Petroleum Co., 435 F.2d 1223, 1228 (10th Cir. 1970) ("Courts have generally been lenient in excusing demand.").

Andre's first reason for failing to demand is that the trustees could not have instituted suit themselves under Section 36(b), so it would have been useless to demand that they do so. The argument is beside the point since the trustees could still take action to ameliorate the controversy, such as themselves renegotiating the advisory contract that gave rise to plaintiffs' complaint. See Markowitz v. Brody, 90 F.R.D. 542 (1981 Transfer Binder) Fed.Sec.L.Rep. (CCH) para. 98,002, at 91, 173 (S.D.N.Y.1981).

Andre's second argument is that two of the eight trustees are interested in the defendant investment advisor. Andre's argument is supported by the one court that has held that a demand on the directors will be presumed futile if there is at least one interested director on the board when the case, like this one, involves a suit under Section 36(b) for excessive compensation to an investment advisor, Boyko v. Reserve Fund, Inc., 68 F.R.D. 692, 696 (S.D.N.Y. 1975).

More recently, however, courts have scrutinized much more closely plaintiffs' reasons for failure to demand. See, e.g., Cramer v. General Tel. & Elec. Corp., 582 F.2d 259, 276 (3d Cir. 1978), cert. denied, 489 U.S. 1129, 99 S.Ct. 1048, 59 L.Ed.2d 90 (1979) (demand would not be futile even though 4 out of 14 directors were interested). Indeed, two of the cases that allowed plaintiffs to make an amendment to include the allegation of a demand made after the filing of the complaint suggest that the mere allegation that two of the eight directors are interested is not a justification for failing to demand. See Markowitz v. Brody, 90 F.R.D. 542 (1981 Transfer Binder) Fed.Sec.L.Rep. (CCH) para. 98,002 (S.D.N.Y. May 20, 1981), at 91,172 ("a Rule 23.1 demand will be excused only when fifty percent or more of the mutual fund's directors are 'interested persons' within the meaning of section 2(a)(19) of the ICA."); Siegel v. Merrick, 84 F.R.D. 106, 110 (S.D.N.Y.1979) (Motley, J.) ("the presence, or even control of, the board by interested directors does not necessarily render a demand futile.") In

this case, there is no allegation that the rest of the trustees are controlled by the two interested trustees. Counsel for Gartenberg has submitted a proposed second, so called, amended complaint, but in reality, a new supplemental complaint which does make such allegations, but has not yet been given permission to amend. Absent such allegations, there was no reason to suspect that the outcome of a demand on a board, three quarters of which is composed of disinterested, independent trustees, would have been unavailing.

Though Andre's reasons fall short of the mark, the fact that in certain circumstances demand may be excused suggests that demand may also be waived by the trustees. In this case, plaintiff's demand of July 14, 1981, two years after the commencement of the suit and four months after the proposed findings and conclusions were filed, was not rejected for untimeliness only, but was refused on the assertion of the judgment of the disinterested trustees on the merits. Consequently, it must be determined by an evidentiary hearing whether that judgment so reached was validly arrived at and whether the facts insulate the advisor from liability and dispose of the suit by a stockholder.

It has been stipulated by the plaintiffs that the supplemental claim, if allowed to be filed, based on a post litigation demand and refusal thereof, is to be deemed filed and operative from the date of filing, September 4, 1981, and that the one year limitary period of damages on the 36(b) claims will be governed by and calculated back from the

date of the assertion of the newly permitted claims.

The effect of allowing a plaintiff, after litigation has been commenced, to construct a sufficient complaint obviously relates to the operation of the short statute in limitations applicable in respect of computable damages. The new claim based upon the July 1981 demand would not relate back to the filing of the insufficient claim in 1979. To rule otherwise would be to expunge the necessity of demand for a valid claim and set Rule 23.1 of the Federal Rules of Civil Procedure at naught. That problem is now bypassed by the stipulation referred to above made by the plaintiffs in open court.

The absence of a demand was pressed specifically only after all pretrial proceedings were complete and a trial date fixed. It is true that the defendants pleaded the absence of demand and reasserted that absence in the proposed findings of fact and legal conclusions as a basis of dismissal of the suit. It is also a fact that the trustees went further and considered the belated, questioned, demand, and reached and announced a judgment on the merits of the claimed breach of fiduciary duty in the suit.

The previous action by the trustees in defense of the suit, termed by the plaintiffs as hostile action, was in a legitimate protection of their substantive defenses, and was not, therefore, indicative of any waiver of the absent demand before suit. The trustees went further after demand was made.

It, of course, goes without saying that nothing herein is to be considered as passing on the validity of the judgment of the trustees on the merits or on the viewpoint of the defendants on the absence of the demand and its implications on the suit. Those matters remain open for consideration on the basis of what the evidence will show concerning the validity of the judgment of the trustees. It also is unnecessary to point out, except for the sake of completeness, that the claims of plaintiffs may not pre-date their stock ownership.

Accordingly, the motion made returnable today by the plaintiffs for leave to serve a supplemental complaint denominated by them second amended, but consisting of a new claim because an essential, previously nonexistent element has now come into existence and been added, will be and hereby is granted in the Court's discretion on a stipulation referred to above that the limitary period shall date from and be governed by the date of the filing of the said supplemental claim. However, it is too late at this stage to accommodate plaintiffs' failure to sue Merrill Lynch and Co. Inc. in the place of Merrill Lynch Pierce Fenner & Smith, Inc. All proceedings herein during the past two years, including the formal findings of fact and conclusions of law presented by both parties to the Court many months ago, have named the latter as the defendant being sued, and it would be inappropriate to substitute a new party, however related that party may be, on the day before the trial commences.

The issues in this case will be heard at trial commencing on September 8, 1981, at 10:00 a.m., in this courtroom.

MR. MANNING: Your Honor, may we have our answer to the earlier complaint deemed the answer?

THE COURT: Is there any objection?

MR. GROSSMAN: No, Your Honor.

THE COURT: Yes. Mutatis mutandis, meaning necessary changes being deemed to have been made.

THE COURT: An application has been made on behalf of the Bank of New York which has received a subpoena duces tecum issued out of the offices of the attorney for plaintiff Gartenberg. For good cause shown and after considering the nature of the request, the subpoena is vacated and set aside.

UNITED STATES COURT OF APPEALS
FOR THE
SECOND CIRCUIT

At a stated Term of the United States Court of Appeals for the Second Circuit, held at the United States Courthouse in the City of New York, on the third day of December, one thousand nine hundred and eighty-two.

Present: HON. WALTER R. MANSFIELD,

HON. ELLSWORTH A. VANGRAAFEILAND,

HON. JON O. NEWMAN,

Circuit Judges,

IRVING L. GARTENBERG, Plaintiff-Appellant, v. MERRILL LYNCH ASSET MANAGEMENT, INC., MERRILL LYNCH, PIERCE, FENNER & SMITH, INC., and MERRILL LYNCH READY ASSETS TRUST, Defendants-Appellees.	NOS. 82-7142 82-7074
SIMONE C. ANDRE, Plaintiff-Appellant, v. MERRILL LYNCH READY ASSETS TRUST, et al.,	

Appeal from the United States District Court for the Southern District of New York.

This cause came on to be heard on the transcript of record from the United States District Court for the Southern District of New York, and was argued by counsel.

ON CONSIDERATION WHEREOF, it is now hereby ordered, adjudged, and decreed that the judgment of said District Court be and it hereby is affirmed in accordance with the opinion of this court with costs to be taxed against the appellant.

A. DANIEL FUSARO
Clerk

by S/ Edward J. Guardaro
Edward J. Guardaro
Deputy Clerk

Investment Company Act of 1940, as amended; Section 15(c); 15 U.S.C. § 80 a-15.

(c) In addition to the requirements of subsections (a) and (b) of this section, it shall be unlawful for any registered investment company having a board of directors to enter into, renew, or perform any contact or agreement, written or oral, whereby a person undertakes regularly to serve or act as investment adviser of or principal underwriter for such company, unless the terms of such contract or agreement and any renewal thereof have been approved by the vote of a majority of directors, who are not parties to such contract or agreement or interested persons of any such party, cast in person at a meeting called for the purpose of voting on such approval. It shall be the duty of the directors of a registered investment company to request and evaluate, and the duty of an investment adviser to such company to furnish, such information as may reasonably be necessary to evaluate the terms of any contract whereby a person undertakes regularly to serve or act as investment adviser of such company. It shall be unlawful for the directors of a registered investment company, in connection with their evaluation of the terms of any contract whereby a person undertakes regularly to serve or act as investment adviser of such company, to take into account the purchase price or other consideration any person may have paid in connection with a transaction of the type referred to in paragraph (1), (3), or (4) of subsection (f) of this section.

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Investment Company Act of 1940,
as amended; Section 36(b),
15 U.S.C. § 80 a-35(b).

(b) For the purposes of this subsection, the investment adviser of a registered investment company shall be deemed to have a fiduciary duty with respect to the receipt of compensation for services, or of payments of a material nature, paid by such registered investment company, or by the security holders thereof, to such investment adviser or any affiliated person of such investment adviser. An action may be brought under this subsection by the Commission, or by a security holder of such registered investment company on behalf of such company, against such investment adviser, or any affiliated person of such investment adviser, or any other person enumerated in subsection (a) of this section who has a fiduciary duty concerning such compensation or payments, for breach of fiduciary duty in respect of such compensation or payments paid by such registered investment company or by the security holders thereof to such investment adviser or person. With respect to any such action the following provisions shall apply:

(1) It shall not be necessary to allege or prove that any defendant engaged in personal misconduct, and the plaintiff shall have the burden of proving a breach of fiduciary duty.

(2) In any such action approval by the board of directors of such investment company of such compensation or payments, or of contracts or other arrangements providing for such compen-

sation or payments, and ratification or approval of such compensation or payments, or of contracts or other arrangements providing for such compensation or payments, by the shareholders of such investment company, shall be given such consideration by the court as is deemed appropriate under all the circumstances.

(3) No such action shall be brought or maintained against any person other than the recipient of such comensation or payments, and no damages or other relief shall be granted against any person other than the receipient of such compensation or payments. No award of damages shall be recoverable for any period prior to one year before the action was instituted. Any award of damages against such recipient shall be limited to the actual damages resulting from the breach of fiduciary duty and shall in no event exceed the amount of compensation or payments received from such investment company, or the security holders thereof, by such recipient.

(4) This subsection shall not apply to compensation or payments made in connection with transactions subject to section 80a-17 of this title, or rules, regulations, or orders thereunder, or to sales loans for the acquisition of any security issued by a registered investment company.

(5) Any action pursuant to this subsection may be brought only in an appropriate district court of the United States.

(6) No finding by a court with respect to a breach of fiduciary duty under this subsection shall be made (A) for a finding of a violation of this subchapter for the purposes of sections 80a-9 and 80a-48 of this title, section 78o of this title, or section 80b-3 of this title, or (B) for an injunction to prohibit any person from serving in any of the capacities enumerated in subsection (a) of this section.

Distribution of Shares by Registered Open-End Management Investment Company

Reg. §270.12b-1. (a)(1) Except as provided in this section, it shall be unlawful for any registered open-end management investment company (other than a company complying with the provisions of section 10(d) of the Act [15 U.S.C. 80a-10(d)]) to act as a distributor of securities of which it is the issuer, except through an underwriter.

(2) For purposes of this section, such a company will be deemed to be acting as a distributor of securities of which it is the issuer, other than through an underwriter, if it engages directly or indirectly in financing any activity which is primarily intended to result in the sale of shares issued by such company, including, but not necessarily limited to, advertising, compensation of underwriters, dealers, and sales personnel, the printing and mailing of prospectuses to other than current shareholders, and the printing and mailing of sales literature.

(b) A registered, open-end management investment company ("company") may act as a distributor of securities of which it is the issuer, Provided That any payments made by such company in connection with such distribution are made pursuant to a written plan describing all material aspects of the proposed financing of distribution and that all agreements with any person relating to implementation of the plan are in writing, and further provided That:

(1) Such plan has been approved by a vote of at least a majority of the outstanding voting securities of such company;

(2) Such plan, together with any related agreements, has been approved by a vote of the board of directors of such company, and of the directors who are not interested persons of the company and have no direct or indirect financial interest in the operation of the plan or in any agreements related to the plan, cast in person at a meeting called for the purpose of voting on such plan or agreements; and

(3) Such plan or agreement provides, in substance:

(i) That it shall continue in effect for a period of more than one year from the date of its execution or adoption only so long as such continuance is specifically approved at least annually in the manner described in paragraph (b)(2);

(ii) That any person authorized to direct the disposition of monies paid or payable by such company pursuant to the plan or any related agreement shall provide to the company's board of directors, and the directors shall review, at least quarterly, a written report of the amounts so expended and the purposes for which such expenditures were made; and

(iii) In the case of a plan, that it may be terminated at any time by vote of a majority of the members of the board of directors of the company who are not

interested persons of the company and have no direct or indirect financial interest in the operation of the plan or in any agreements related to the plan or by vote of a majority of the outstanding voting securities of such company; and

(iv) In the case of an agreement related to a plan.

(A) That it may be terminated at any time, without the payment of any penalty, by vote of a majority of the members of the board of directors of such company who are not interested persons of the company and have no direct or indirect financial interest in the operation of the plan or in any agreements related to the plan or by vote of a majority of the outstanding voting securities of such company on not more than sixty days' written notice to any other party to the agreement, and

(B) For its automatic termination in the event of its assignment; and

(4) Such plan provides that it may not be amended to increase materially the amount to be spent for distribution without shareholder approval and that all material amendments of the plan must be approved in the manner described in paragraph (b)(2);

(5) Such plan is implemented and continued in a manner consistent with the provisions of paragrapsh (c), (d) and (e) of this section;

(C) A registered open-end management investment company may rely on the provisions of paragraph (b) of this section only if selection and nomination of those directors who are not interested persons of such company are committed to the discretion of such disinterested directors;

(d) In considering whether a registered open-end management investment company should implement or continue a plan in reliance on paragraph (b) of this section, the directors of such company shall have a duty to request and evaluate, and any person who is a party to any agreement with such company relating to such plan shall have a duty to furnish, such information as may reasonably be necessary to an informed determination of whether such plan should be implemented or continued; in fulfilling their duties under this paragraph the directors should consider and give appropriate weight to all pertinent factors, and minutes describing the factors considered and the basis for the decision to use company assets for distribution must be made and preserved in accordance with paragraph (f) of this section;

NOTE: For a discussion of factors which may be relevant to a decision to use company assets for distribution, see Investment Company Act Releases Nos. 10862, September 7, 1979, and 11414, October 28, 1980.

(e) A registered open-end management investment company may implement or continue a plan pursuant to paragraph (b) of this section only if the directors

who vote to approve such implementation or continuation conclude, in the exercise of reasonable business judgment and in light of their fiduciary duties under state law and under sections 36(a) and (b) [15 U.S.C. 80a-35(a) and (b)] of the ACt, that there is a reasonable likelihood that the plan will benefit the company and its shareholders; and

(f) A registered open-end management investment company must preserve copies of any plan, agreement or report made pursuant to this section for a period of not less than six years from the date of such plan, agreement or report, the first two years in an easily accessible place.